

Paris, January 14, 2008

Dear members of the Working Party,

Please find hereinafter our comments on the OECD's public discussion draft published on October 20, 2007, on the subject of "Tax Treaty Issues Related to REITs."

Introduction

After having read your report with much interest, we wish to submit to you our following observations and suggestions regarding the issues relating to French REITs in an international context.

For purposes of clarifying the situation of French REITs, we will first present to you the tax situation of French REITs in light of the relevant Community principles, since, for the 27 countries of the European Union, the Community rules prevail over treaty rules. Then, we will provide you with our comments and suggestions with respect to the report presented by the Working Party.

1 Tax situation of French REITs in light of European Community principles

Scenario no. 1: investment of a French REIT in real estate located in the EU or of an EU REIT in real estate located in France

Where a REIT of another EU member country holds real estate located in France, it may, under certain conditions, be entitled to the same exemption as a French REIT of the same kind. The opposite, however, is not always true: a French REIT may be taxed abroad on real estate income even if it has characteristics comparable to a REIT residing in the country where the real estate is located.

Scenario no. 2: The French REIT distributes dividends to EU investors

Where a French REIT distributes dividends to its EU investors, the distribution is subject to a French withholding tax (hereafter "WHT") of up to 25% on a gross basis (this rate may be reduced on the basis of tax treaties). If the investor had been French, it/he would have been subject to corporate income tax (34.43%) or personal income tax on a net basis. Thus, except for the different basis that might exist if the investor were French and except where the investor is in a loss situation, French legislation seems to be in conformity with Community law.

Scenario no. 3: The EU investor sells his interest in a French REIT

Where a foreign investor sells his interest in a French REIT, the sale is exempt in France if the foreign investor holds less than a 10% stake in the French REIT. If the foreign investor holds at

least 10% of the French REIT's capital, the sale of its/his interests in the REIT would be subject, in the absence of tax treaty provisions, to French withholding tax as follows:

- Individual foreign investor: 33.1/3% withholding tax, or 16.5% in the EU;
- Foreign legal entity investor: 33.1/3% withholding tax, or 16.5% if the company is listed and the investor is in the EU.

French-resident investors are subject to taxation at similar rates. French law thus seems to be in conformity with Community law on this point as well.

These three scenarios should be encountered in every EU Member State that has instituted a REIT regime. In addition, at least three difficulties arise from a Community standpoint:

- the “merger” (90/434/EEC), “parent-subsidiary” (90/435/EEC) and “interest and royalty” (2003/49/EC) directives apply only to companies that are liable to – and not exempt from – corporate income tax; accordingly, REITs should not be able to benefit from these directives, though this all depends on how they were transposed into domestic law by the various Member States;
- according to ECJ case law, the interrelationship between tax treaties and Community law is not yet entirely clear. It seems that the issue of conformity to Community law is assessed with respect to domestic law alone, and that the application of the treaty is considered to determine whether or not the claimant suffered any harm as a result of a non-conformity;
- the case of REITs is comparable to that of UCITSs, which raise great theoretical and practical difficulties under Community law, such as that of determining the level at which the discrimination issue should be assessed: at the level of the investment vehicle (the REIT) or the investor. An additional difficulty relates to the notion of “comparable situation” when a given Member State does not have a genuine REIT regime or when its REIT regime is quite different from that of the other EU Member States (this situation also arises, for example, for certain UCITS: cf. C-303/07, Aberdeen Property Fininvest Alpha).

2 Definition of REITs / Distinguishing between REITs according to how open their capital is

As a preliminary comment, we wish to underscore that the solutions currently being studied by the OECD could, in the event of the application of a high withholding tax rate, deter foreign investors from structuring their investments through a REIT.

The ultimate result might therefore be the opposite of what was initially intended, i.e. an increase in the source-State's tax revenue on the real estate profits realized by the REITs.

In light of the current worldwide context (financial crisis) and the general sluggishness of the REITs market, it is more than necessary not to destabilize the REITs market by taking measures which, while motivated by a concern for legal equity, would not be economically satisfying.

The primary risk would be to see investors turning away from REITs in favor of other more fiscally attractive structures, such as private equity funds.

In addition, with respect to the French REIT market, and more specifically the SIIC market (which is currently the most widespread form of French REIT), we wish to point out that the election for the exempt treatment of real estate income, for a minimum 10-year period, is subject to the SIICs' payment of an exit tax of 16.5% on all of their unrealized capital gains. We therefore feel that the OECD should take into account these particular conditions of entry into the REIT regime, both for current SIIC investors, so that their investments are not significantly compromised, and for future investors, for whom the application of a standard-rate withholding tax (25% for France) would undoubtedly be a deterrent to any investment in REITs.

Thus, in light of the proposals made by the Working Party, we feel it is useful to pay special attention to the following points, which we will address below in the following order:

- The distribution of dividends by a French REIT
- The application of international tax treaties to REITs
- The realization of capital gains on the sale of interests in French REITs
- A French REIT's investment in foreign real estate or in a foreign REIT

2.1 Distribution of dividends by a French REIT to foreign investors

Proposals of the OECD report

The OECD report proposes to have the income distributed by REITs considered as dividends, regardless of the nature of the REIT (i.e., whether it is a pass-through vehicle or not), though without affecting the local treatment of the REITs. However, a distinction is proposed between (i) "small investors," who seek an actual return on investment and who should be able to benefit from the reduced WHT rates provided for by the OECD model, and (ii) "large investors," who use the REITs as a substitute for direct investments in real estate and should not benefit from the reduced WHT rates.

To this end, the report proposes to apply a 10% threshold (which countries may adjust) and to make a distinction between the taxable bases of:

- small investors (investors holding less than 10% or any other threshold that may be determined by the States), who would be subject to a maximum 15% WHT rate, which would be applicable to them in accordance with the OECD model convention without being able to benefit from the extra-reduced rate of 5%, on a gross basis.
- and large investors (holding at least a 10% interest in the REIT), who could, for their part, be subject to a full-rate WHT in the country where the REIT is located, on a net basis.

The report, however, would authorize States to adopt a different threshold in cases where the distribution is made out of REIT income that corresponds to a capital gain.

Lastly, it is proposed that anti-abuse clauses be set up in order to prevent large investors from (i) spreading out their investments to benefit from the reduced WHT rate provided for small investors and/or (ii) selling their interests before the REIT makes a distribution and then re-purchasing interests in the same REIT.

Our proposals

We wish to underscore that, with respect to SIICs (the most well-known form of REIT in France) French domestic law encourages the dispersion of capital, by (i) forcing SIICs not to have more than 60% of their capital held by one investor or by several investors acting in concert, failing which the regime is forfeited, and (ii) providing for a 20% levy on dividends distributed to a legal entity that is not subject to corporate income tax on such dividends and owns (directly or indirectly) at least 10% of the SIIC's capital.

In light of the investments made in French REITs, we think it would be more advisable to make the following distinction between two types of REITs; however, please note that the comments below are limited to taxable (i.e., not pass-through) REITs (e.g., SIICs and Sppicav):

- “closed” REITs whose capital is open only to a limited number of investors, mainly institutional investors (e.g., club deals)
- and “open” REITs whose capital is open both to the public and to institutional investors.

It seems to us that this distinction should be founded upon criteria established under securities law and/or finance law (in particular, the rules aimed at protecting savers and investors, even if this entails setting up certain anti-abuse mechanisms such as a “limitation on benefits – LOB”), rather than upon a fixed capital ownership threshold which also refers to indirect ownership. In our opinion, this would serve to prevent situations wherein, in good faith, a REIT that is unaware that one or several of its investors is in fact a large investor, applies a reduced withholding tax rate and then becomes subject to a reassessment which, de facto, might be economically borne by all the investors.

A REIT whose capital is not widely owned (i.e., a “closed” REIT) is a vehicle dedicated solely to institutional investors whose main purpose is not distributive. Indeed, the profits realized by investors in such REITs occur mainly upon the sale of their REIT interests, when they hope to obtain high capital gains. We therefore consider that the OECD's approach relating to large investors could indeed be applied to such REITs.

In other words, the dividend distributions would be subjected to a full-rate withholding tax by the country where the REIT is located, on a net basis, with no possibility of applying the treaty WHT rate applied to dividend distributions (15%), and the capital gains realized on the sale of the REIT interests would be taxable only in the State where the real estate is located.

This approach would offer the advantage of placing “closed” REITs on an equal tax footing with private equity funds.

However, for large investors, the application of a tax by the source-State raises the issue of the taxable basis. Whether with respect to the withholding tax on dividends or the taxation of capital gains, the foreign investor should be able to offset, against its taxable basis, all the expenses borne upon the purchase and incurred throughout the holding period of the investment. In the absence of harmonization of the rules on taxable bases, it will be critical to determine what

offsetting rules should apply for purposes of determining the net taxable basis. In addition, only distributions taken out of exempt income should be subject to said regime. Any distribution taken out of income that was subjected to corporate income tax or the 16,5% exit tax payable upon the REIT's entry into the exemption regime should be eligible for the reduced treaty rate.

Lastly, it should be pointed out that, with respect to dividends, the total amount of levies at source made by the State may not exceed the standard rate of withholding tax. We refer more specifically here to the French 20% levy mentioned above. We consider that such a levy should be deducted from the withholding tax applicable in the event of a dividend distribution.

As regards "closed REITs," it seems to us that the OECD model convention could go as far as adopting a "quasi pass-through" approach, by providing that Article 6 is applicable to distributions made by REITs.

Conversely, "open" REITs which, unlike "closed" REITs, have a strong distributive function, should be treated in a manner similar to open UCITS, to which indeed they are similar in nature. We therefore feel that the tax treatment applicable to dividend distributions and capital gains that the OECD report proposes for small investors could be applied to all investors in "open" REITs, without making any distinction between small and large investors.

Indeed, in this case, the difference in treatment between small and large investors seems inappropriate to us, as all investors in an open fund should be subject to the same tax treatment, insofar as, from a legal standpoint, it is incorrect to consider that an investor who holds at least 10% in a REIT thereby holds a controlling interest over the REIT's assets.

The explanation for our position is that an investor in an "open" REIT expects an annual return on investment (which he will obtain in the form of a dividend) and does not (unless he diverges from the spirit of "open" REITs) seek to (indirectly) own real estate, unlike "closed" REIT investors whose decision to invest in real estate is based on "quasi pass-through" considerations. A large investor's investment in an open fund is based more on investment diversification considerations than on "real estate" investment considerations per se.

2.2 Application of international treaties to REITs

Proposals of the OECD report

According to the terms of the OECD report, and in order to allow REITs to benefit from treaty provisions where they do not have resident status, it is proposed to grant them the benefit of certain treaty provisions. To this end, the Working Party proposes to insert a special mechanism in the Article of the OECD model dealing with received and/or distributed income relating to REITs (i.e. either Article 6 relating to real estate income or Article 10 relating to dividends), and/or in the article dealing with capital gains realized on the sale of interests in REITs (Article 13 relating to capital gains).

Our proposals

The OECD report thus limits the concept of residence to certain articles of the OECD model convention. We feel, however, that it would be preferable to insert a general provision either into Article 1 of the OECD model (concerning the persons covered by the treaty) or into Article

4 (concerning the definition of resident) in order to enable REITs to benefit from the other treaty clauses as well (e.g., the non-discrimination clauses).

An even more precise approach could be contemplated, wherein a distinction is made between REITs that already meet the definition of “resident” under the OECD model convention and REITs that do not meet this definition. The latter could:

- Either be treated, purely and simply, as residents (which would appear to be the simplest approach);
- Or, again taking up the distinction between “open REITs” and “closed REITs,” provide that “closed REITs” would be residents solely on the basis of the residence of their investors, whereas as “open REITs” would be treated in the same manner as “open UCITS” (provided, however, that the situation of “open UCITS” with respect to tax treaties is, itself, clarified by the OECD model convention).

2.3 Scenario no. 3: where the foreign investor realizes capital gains further to the sale of its interests in a French REIT

Proposals of the OECD report

As with dividend distributions, the OECD report proposes to modify the OECD comments concerning the treatment of capital gains realized on the disposal of REIT interests according to the nature of the investor (small / large investors).

For large investors, it proposes to treat capital gains on sales of REIT interests like capital gains arising from the alienation of shares that derive over 50% of their value, directly or indirectly, from real estate assets located in another contracting state (Article 13§4 – taxation in the source country).

Conversely, it thus proposes to exclude the capital gains realized by “small investors” from §4 of Article 13. They would thus be subject to the regime provided for by §5 of Article 13, which confers the right to tax on the State where the seller is resident.

This proposal would be left up to the choice of the States. Indeed, insofar as §4 of Article 13 is also meant to apply to listed companies, and as there is no reason to distinguish REITs from listed companies, certain States could consider that no distinction should be made between small and large investors and thus apply Article 13§4 in both cases.

Our proposals

Using the case of French REITs to illustrate the point, we thought it would be helpful to distinguish between two situations where the foreign investor realizes capital gains on the sale of its interests in a REIT.

On the one hand, where the French REIT holds a majority of its assets in France (i.e., the French assets represent over 50% of the total value of the assets held by the REIT), we reiterate our proposal to apply the abovementioned distinction between:

- “closed” REITs (the capital gains are taxed solely in the State where the real estate is located – Article 13§4 of the OECD model convention),
- and “open” REITs, without distinguishing between small and large investors (the capital gains are taxed in the seller’s State of residence – Article 13§5 of the OECD model convention).

On the other hand, where the French REIT does not hold a majority of its assets in France, and particularly where these real estate assets are spread across numerous countries, we consider that it would no longer be logical to apply, for “closed” REITs, the above-described rules resulting from the application of Article 13§4 of the OECD model convention. It would thus seem to us more logical and simpler, in cases where a “closed” REIT holds assets in at least 3 (for example) countries, to confer the right to tax on the investor’s State of residence alone.

2.4 Scenario wherein a French REIT invests in foreign real estate or a foreign REIT

Proposals of the OECD report

The OECD report proposes three different approaches to a domestic REIT’s receipt of income deriving directly from real estate located abroad or of income deriving from foreign REITs. The common goal of these methods is to avoid any taxation upon the repatriation of the income realized by the REITs and to allow for taxation upon the distribution of this income to the investors.

We will refer to the REIT that is closest to the non-REIT investor as the “feeder REIT.”

The first approach consists in exempting the income from domestic tax when such income is realized, and then taxing the foreign income in the source country when the feeder REIT makes a distribution.

The second approach consists in considering the immovable property income derived from a State by a foreign REIT as similar to income realized in the source State, and then deeming the existence of a dividend distribution between the source State and the State where the feeder REIT is located, and subjecting this distribution to the provisions of Article 10 of the OECD model convention between the two States.

Lastly, the third approach consists of considering the feeder REIT as having a permanent establishment in the source State, and then deeming that a distribution of income is made between said establishment and the feeder REIT, which can be taxed on the basis of Article 10 of the OECD model convention.

Our comments

As is often the case with triangular situations, this is undoubtedly the most complex scenario.

We would also like to draw the Working Party’s attention to the following points:

- How to eliminate the double taxation where the feeder REIT’s distribution gives rise to a withholding tax in the State where it is located and the REIT is unable to use the tax credit corresponding to the tax it has withheld (e.g., no taxable base)?

- What treaty would be applicable if the feeder REIT's foreign investor is located in the country where the real estate or foreign REIT is located (i.e., in the same country as the source of the income)?
- What about the elimination of withholding taxes in the event of a chain of REITS?
- Should a foreign REIT's distribution to a feeder REIT be considered as a crystallized distribution to a given investor or does it merely constitute income for the feeder REIT (problem of traceability)?

Our proposals

We feel that the three methods proposed by the OECD would be very difficult to implement in practice.

We therefore wonder about the possibility of applying a mechanism wherein a dividend distribution would be presumed to take place upon the distribution of foreign income to the feeder REIT (which presumption might be akin to the one recognized and applied in France under Article 115 *quinquies* of the FTC), with the possibility of offsetting the withholding tax against the other withholding taxes that would apply in the event of a chain of REITs.

Example:

A German REIT pays out a distribution of 100 to a French REIT which is subject to a WHT of 15.

The French REIT is exempt on this distribution, provided that it redistributes this sum to its shareholders. If the 85 (100-15) bears a 25% withholding tax, the total withholding amounts to $15 + 21.5 = 36.25$, i.e. a total taxation of 36.25%! It could be provided, under Article 23 of the OECD model convention, to offset the WHT of 15 against the WHT of 25, so as to obtain the same level of taxation in the State of the feeder REIT (France) as that which would have applied if the income had been of French source $[15 + [(25\% \times (85+15))] - 15] = 25\%$.

By again applying the "open / closed REIT" distinction (cf. above), we could favor either a "pass-through" approach (if the feeder REIT is "closed", by taking into account the residence of the investors) or an "open REIT" approach (if at least one of the REITs in the chain is open).

We thank you in advance for the attention you would pay to our comments.

Best regards,

Marc Cretté
Attorney at Law
International Tax Partner

Laurent Leclercq
Attorney at Law
International Tax Partner