EPRA

Follow-up work on Action 6: prevent Treaty Abuse

Introduction

EPRA has taken note of OECD's invitation – made in the public discussion draft " Follow-up work on BEPS Action 6: Preventing Treaty Abuse", dated 21 November 2014 (**Follow-up Discussion Draft**) - to submit comments on the preliminary proposals published by the OECD in connection with the prevention of the granting of treaty benefits in inappropriate circumstances. In particular, EPRA wishes to comment on the issues related to the application of the proposed anti-abuse provisions to collective investment vehicles.

Reference is made to EPRA's submission dated April 9, 2014, as well as the EPRA submission dated May 23, 2014, containing the comments of eleven European professional real estate associations. In both submissions, clarification was asked for on the position of "Real Estate Investment Trusts" (**REITs**) in connection with the proposals on the prevention of treaty abuse.

Herein below, EPRA will:

i. re-iterate the importance of REITs to the world's economy,

ii. make some observations on the particular position of REITs,

iii. outline the major problems that the proposals contained in the OECD's proposals to prevent treaty abuse will have for the REIT industry,

iv. indicate how the proposals should be amended to eliminate the potential substantial and serious adverse consequences for REITs worldwide.

Importance of REITs

The use of Real Estate Investment Trusts ("**REITs**") has significantly expanded worldwide and has a very substantial impact on today's economy.

REIT regimes have been introduced over the years as a means to:

- Attract capital into the built environment/infrastructure through broad access of capital markets with daily liquidity;
- Make the benefits of investing into commercial real estate accessible for both institutional investors and small investors;
- Transparent business and markets reports through analysts and regular reporting;
- Professionalise the property sector (normally through the growth of the publicly quoted property sector) and create a more international level playing field;
- Lower the cost of capital for commercial property businesses;

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- Prevent the proliferation of offshore property funds/private ownership.

In summary, we believe that the overall purpose of REITs can be described as achieving the objectives of

1) making the commercial real estate market more accessible to investors,

2) improving the quality and efficiency of the end-product – the built environment, which is extremely important to sustainable economic growth and development,

3) providing long-term capital perfectly matching the investors' expectation for long term, stable returns.

The OECD has previously recognised the importance of REITs in its 2007 REITs report. REITs are increasingly investing cross-border, despite the fact that their privileged tax regime is typically not available in foreign jurisdictions resulting in full tax liability there. In the 2007 REITs Report, the OECD made reference to the legitimate concerns of the industry participants (including at the time EPRA representatives) in the group that prepared such report by indicating 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"*[1].

In addition, the OECD has recognised that "*one of the primary purposes of tax treaties is to reduce tax barriers to cross-border trade and investment*"[2]. REITs with just one layer of final tax (at shareholder level) are simple and non-aggressive in eroding a tax base of the *res situs* territory.

The position of REITs

In the substantial September 2014, report on "preventing the granting of treaty benefits in inappropriate circumstances (**the Abuse Report**), the acronym "REIT" was only used in connection with an example that was given of an existing model tax treaty provision containing an anti-abuse rule. Otherwise, no attention was given to the REIT at all.

In the subsequent Follow-Up Discussion Draft of November 2014, the following is noted (paragraph 5):

> *"Whilst changes were made in the final version of the Report in order to deal with collective investment vehicles, no such changes were made to address comments that were received on the March 5 2014 discussion draft in relation to Real Estate Investment*

[1] Public discussion draft on Tax Treaty issues related to REITs, 30 October 2007, p. 13.
[2] The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles, adopted by the OECD Committee of Fiscal Affairs on 23 April 2010, p. 3.

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Trusts (REITs),1 sovereign wealth funds (SWFs), pension funds and alternative funds (including private equity funds)."

The footnote elaborates as follows on the position of REITs:

"REITs are covered by the 2010 Report on CIVs to the extent that they are widely-held and regulated. When that is not the case, they may face the issues described below in relation to alternative funds / private equity funds (see subsection iii))."

However, the 2010 Report on CIVs does not refer to REITs. Rather, REITs are covered by the OECD public discussion draft of October 30, 2007, entitled "Tax Treaty Issues Related to REITs" (**the 2007 REITs Report**)[3]

Today, the definition of REITs has been widely accepted as it has been set out in the 2007 REITs Report and implemented into the 2008 OECD Model Tax Convention. REITs offer a specific taxation for real estate investments shifting the tax liability to the investor level rather than the vehicle itself.

There are various types of collective investment schemes built on national or EU harmonised investment fund legislation (AIFMD - Alternative Investment Fund Managers Directive) which invest in securities or any other alternative assets (hedge strategies, infrastructure, real estate etc.). In the OECD terminology, these vehicles are called "non-CIVs" (i.e., alternative investment funds like private equity funds, non-listed real estate funds, infra structure funds, hedge funds, etc.). These non-CIVs, are designed with a view to offering safe and regulated investment funds with many different strategies and asset classes and the goal of sound investor protection of private or institutional investors.

Contrary to non-CIVs, in most countries REITs are not subject to the regulatory supervision legislation that applies to these non-CIVs. For example, in most EU countries, REITs are not subject to the AIFMD. REITs are in many cases listed at the stock exchange and subject to the rules that apply to the listed sector. From a tax point of view, REITs benefit from a "flow through" regime (unlike most non-CIVs). EPRA wishes to ensure in respect to BEPS Action 6, the OECD will treat REITs as a separate class of investment vehicles, as confirmed in line with the cited OECD work related to REITs and CIVs.

A REIT is a going concern business activity led by a board, typically listed and widely held over recognised stock exchanges. REITs are a globally accepted capital market based asset class. Therefore, it remains correct to continue to treat such an operation, regardless if it is constituted as a trust or a corporation, as a person with access to tax treaties. That has been also the position of the US treaty practice for many years, from which OECD has taken the concept of the LOB.

[3] Public discussion draft on Tax Treaty Issues related to REITs, 30 October 2007, p. 3.

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Analysis of the adverse impact of the Abuse Report on REITs

As mentioned above, the OECD has recognised the importance of REITs and the need to remove tax obstacles and barriers that hinder cross-border investments. The objective of REIT regimes in many countries is to support the development of the property sector and to realise the objective of achieving tax neutrality between direct and indirect investment in real estate by pension funds, insurance companies, sovereign funds and the retail investors.

One of the key features of a REIT is that the point of taxation is moved from the entity (the REIT) to the shareholders. Moreover, substantially all REIT regimes contain specific provisions preventing abusive use of REITs and the possibility of undesired treaty shopping. Should these provisions not be in place, then countries would risk their taxing rights in respect of the property income earned by REITs. This is why substantially all REIT regimes provide for a "waterproof" system, whereby the property income is subject to tax on an annual basis based on the mandatory distribution of the REIT and the corresponding withholding taxes.

Moreover, most REITs are either stock listed, or subject to regulatory supervision with all related and appropriate reporting and transparency requirements. Dividends distributed by REITs are invariably subject to withholding tax. Hence, REITs can be seen as a solid concept to prevent the proliferation of offshore property schemes and aggressive tax structures, the exact type of structure, which the Abuse Report is focusing on. In addition, REITs are almost ideal taxpayers as the REIT withholding tax is flowing consistently with mandatory distributions which are made regularly, in some cases even monthly.

However, if the Abuse Report was to be implemented as proposed, it may well lead to the result that access to tax treaty benefits is denied to many *bona fides* REITs.

To illustrate this, we have applied the various tests in the suggested limitation on benefits provision (**"the LOB"**) to REITs with the following results:

1. *Legal form*: Considering their legal form, REITs are generally not qualified persons under paragraph 2.a) and 2.b) of the LOB ("company").

2. *Stock exchange test*: REITs have to fulfil one of the following tests, mentioned under a) and b) below:

   a) REITs should either (i) be listed on a recognised stock exchange located in the Contracting State where the company is resident or (ii) be listed on a recognised stock exchange and the company's primary place of management and control should be located in the Contracting State where the company is resident.

      There does not seem to exist a valid reason to limit the listing of the REITs to recognised stock exchanges located in the Contracting State where the company is resident and in various cases, this test will not be met. A listing can be obtained and maintained at different stock exchanges for various

commercial and regulatory reasons. Moreover, it is frequently the case that participations in REITs are traded in secondary markets, that do not fall under the definition of recognised stock exchange, or that a REIT is widely held, but not listed at an official stock exchange.

b) At least 50% of the company (voting power and value of shares) is owned directly or indirectly (with each intermediate owner being resident in either Contracting State) by five or fewer listed companies.

Under the current market practise, where many REITs have a broad international investor base, including other REITs – this being one of their advantages in order to raise the required capital for large institutional / infrastructural property projects - this test is highly unlikely to be met. Moreover, REITs often invest via subsidiaries situated in other States. These subsidiaries would often not qualify for this 'derivative stock exchange test'. The 'same state' requirement, as well as the requirement that each intermediate owner is a resident of either Contracting State, are unnecessarily complicating things for REITs. There is no reason why a widely held vehicle listed at a regulated stock exchange should suffer disadvantages depending on its ownership base. A listed vehicle like a REIT is constituted to flexibly attract capital from whichever part of the world and the key element for granting treaty benefits is that the REIT has a business led by a central management and qualifies as a resident in a treaty country as defined by the treaty terms.

3. *Charities/ Pension funds*: REITs do not fall within the scope of the qualified persons under paragraph 2.d) of the LOB.

4. *Shareholders' test / equivalent beneficiary test:* REITs may be considered as qualified persons under paragraph 2.e) of the LOB if the following two conditions are met:

a) At least 50% of the REIT (voting power and value) is owned, directly or indirectly (with each intermediate owner being resident in the State of residence of the REIT) in the hands of qualified persons (as described in 2.a), 2.b), 2.c).i) or 2.d) of the LOB) which are resident of the Contracting State where the REIT is resident.

As previously mentioned, under current market practice, many REITs have a broad international investor base, including other REITs, and such condition is highly unlikely to be met. Moreover, also REIT subsidiaries located in other countries will not be able to benefit from this provision. It would be a major distortion of the international capital markets if REITs where *de facto* forced to restrict their ownership base in such a way. Since it has to be accepted that a widely held company with active trading of shares has to serve the purpose for

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its shares being fully tradable any time without uncontrollable adverse tax consequences, such restriction is unrealistic for REITs.

b) Less than 50% of the income of the REIT's tax income, is deducted by the REIT and paid or accrued, directly or indirectly to persons that are not residents of the Contracting State where the REIT is resident and are not considered as qualified persons (as described in 2.a), 2.b), 2.c).i) or 2.d) of the LOB).

Under the domestic tax law of many countries, in order to achieve the desired look-through approach in respect of REITs, REITs are required to distribute most of the income they have received as dividends to their participants and REITs are entitled to deduct from their tax base such income. In respect of REITs located in countries with this type of provisions, this second condition would neither be met. Furthermore, it effectively narrows the broad access to capital markets that REITs focus on.

Based on the above, it is unlikely that REITs meet the conditions set out in paragraph 2.e) of the LOB in order to be considered as qualified persons.

5. *Substantial business test:* Paragraph 3 of the LOB contains a "substantial business test". However, it is uncertain whether REITs would pass this test and the business of making investments for its own account directly or indirectly could very well be excluded as a qualifying activity, based on paragraph 3.a) of the LOB.

6. *Derivative benefits test:* on the basis of Paragraph 4 of the LOB, a company will get treaty access if it is owned for 95% or more by equivalent beneficiaries. An equivalent beneficiary is an entity that would have been entitled to at least the same treaty benefit had the relevant treaty income flowed directly to such entity. In addition, a base erosion test is imposed.

   Again, given the widely held character (REITs often do not avail of the identity of all of its shareholders), it will be impossible to qualify for this test.

7. *Competent authority procedure:* Paragraph 5 of the LOB provides the possibility that competent authorities determine on case by case basis the application of the particular tax treaty (discretionary relief). However, it is well known that such request would involve an additional administrative burden for the REITs, with a highly uncertain outcome. Unless REITs would genuinely be accepted as treaty persons as promoted by the 2007 OECD REITs Report.

As the illustration of the application of the LOB to REITs clearly demonstrates, the Abuse Report goes too far in restricting tax treaty access, without having a clear notion of where genuine use of tax treaties ends and where abuse starts. It seems as if the balance may flip to the other side: instead of tax treaties being primarily instruments to avoid double taxation, their objective would shift to merely prevent international tax avoidance.

It is clear that REITs will be severely affected by the Abuse Report and that many REITS face the risk of access to tax treaty benefits being denied. Being unable to access tax treaties may result in REITs being faced with a significant degree of uncertainty and with constant double taxation, which would result in an increase of the costs of cross border investing.

The Abuse Report is part of the exercise to prevent double non-taxation and cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it. However, implementation of the recommendations in the Abuse Report in their current form would seriously hamper the interests of *bona fides* legitimate REITs and cross-border investors, without realizing the impact that this would have on the global economy, in particular on the international property market, where REITs play a fundamental role.

EPRA urges the OECD to reconfirm the recognition which has been granted by the 2007 REITs Report to REITs. REITs are one of the most transparent, simple and least tax aggressive investment forms which build capital through pensions funds, insurance companies and sovereign wealth funds allocating their resources to diversified REITs.

Suggestion of additional wording on the LOB

As explained above, REITs should be excluded from the scope of the “suspected persons”. EPRA suggests that REITs as defined in the 2007 REITs Report, as well as persons wholly-owned by REITs, be considered qualified persons for purposes of the LOB rule.

Moreover, EPRA invites the OECD to take the “principal purpose test” out of the Abuse Report and include in the Abuse Report the specific recommendations approved by OECD Working Party No. 1 on Tax Conventions and Related Questions in the 2007 REITs Report.

About EPRA

EPRA is the voice of the publicly traded European real estate sector: it is the representative association for commercial property companies that are quoted on the public stock exchanges of Europe and other exchanges around the world. With more than 200 active members, EPRA represents over EUR 350 billion of real estate.

EPRA’s membership also includes the institutional investors such as pension funds and insurance companies that invest in, or have an interest in investing in real estate indirectly via these listed property companies. Through the provision of better information to investors, improvement of the general operating environment, diffusion of best practices and the cohesion and strengthening of the industry, EPRA works to encourage greater investment in listed real estate companies in Europe with long-term and stable income producing assets.

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