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VIA EMAIL: taxpublicconsultation@oecd.org

International Cooperation and Tax Administration Division
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development

Re: Global Anti-Base Erosion Proposal (GloBE) – Pillar Two and Real Estate Investment Trusts (REITs)

Ladies and Gentlemen:

This letter is a follow up to the Dec. 2, 2019 letter submitted by Nareit[1] to provide comments on the Public Consultation Document *Global Anti-Base Erosion Proposal (GloBE) – Pillar Two*, which was released by the OECD on Nov. 8, 2019. Our comments in that letter focused on how the risk that new minimum tax rules developed under the GloBE proposal could inappropriately capture REITs if their special circumstances are not considered in the design of such rules.

In that letter, we urged the OECD to incorporate specific rules for REITs in the design of the GloBE proposal since REITs do not raise the tax policy issues that are the target of the work under Pillar Two and the potential application of new minimum tax rules to REITs would undermine the policies underlying the REIT regimes that are in place in the United States and many other countries around the world.[2] Finally, providing special rules for REITs that prevent the imposition of minimum taxes under the GloBE proposal would be consistent with the OECD's long history of recognizing the special circumstances of REITs through the inclusion in its guidance of specific rules ensuring the appropriate treatment of cross-border investment in and by REITs.

This follow up letter is intended to serve two purposes: first, to provide additional information regarding the requirements to which U.S. REITs must adhere in fulfilling the REIT regime's important public policy objectives; and second, to make a more specific recommendation for how REITs could be excepted from this proposal.

[1] Nareit is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. Nareit advocates for REIT-based real estate investment with policymakers and the global investment community. Through the properties they own, finance and operate, REITs help provide the essential real estate we need to live, work and play. All U.S. REITs own approximately $3 trillion in gross assets, public U.S. REITs account for $2 trillion in gross assets, and stock-exchange listed REITs have an equity market capitalization of over $1 trillion. In addition, about 87 million Americans invest in REITs.
[2] About 40 countries have adopted REIT rules, including 21 of the 37 OECD member countries. https://www.reit.com/investing/global-real-estate-investment.

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Operation of U.S. REITs

REITs serve an important public policy objective by providing a means for individuals, without the financial wherewithal of substantial investors, to invest in real estate by acquiring shares of a REIT in order to achieve the important goal of diversifying investment savings. These investments also assist REITs with raising capital to invest in real estate holdings on a long-term basis.

Although REIT regimes differ around the world, U.S. REITs are entities subject to tax as corporations but that are allowed a "dividends paid deduction" for distributions paid to their shareholders. Since REITs essentially distribute 100% of their taxable income annually, no income tax is paid at the entity level. However, the individual shareholders of REITs, whether their shares in the REITs are held directly or through mutual funds or other investment vehicles, pay a higher income tax on the distribution than shareholders of non-REIT corporations, which are under no obligation to distribute dividends[3]. Since REITs distribute all of their taxable income annually, rather than on a deferred basis as non-REIT corporations may do, REIT shareholders pay taxes on this income currently.

The OECD's Position on REITs

Historically, the OECD has recognized the importance of REITs, their international expansion, and the related implications. For example, in 2007 the OECD issued a draft report to address certain treaty issues arising in the REIT context.[4]

Also REITs were addressed by the OECD in the final reports from the OECD/G20 BEPS Project that were released on Oct. 5, 2015. In the report on Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances), the OECD reconfirmed the treatment of REITs as residents capable of securing tax treaty benefits.

The final report on Action 2 (Neutralize the Effect of Hybrid Mismatch Arrangements) also specifically addressed REITs. The OECD noted that "[h]ybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral by, for instance, creating two deductions for one borrowing, generating deductions without corresponding income inclusions, or misusing foreign tax credit and participation exemption regimes." The concern raised for REITs was that a REIT could be considered a "hybrid" because it may deduct distributions (through the dividends paid deduction), but certain recipients (e.g., pension funds) in certain countries do not currently include those distributions in

[3] The highest tax rate (other than the Medicare surtax) on ordinary dividends to REIT shareholders (after reflecting the 20% deduction under section 199A) is 29.6%, whereas the highest rate on dividends from non-REIT corporations is 20%.
[4] Tax Treaty Issues Related to REITs, Public Discussion Draft. 30 October 2007.

taxable income – hence the "mismatch." Action 2 contemplated changes to domestic country tax law in order to address "hybrid mismatch" situations. Theoretically, this consideration could have required an elimination of the dividends paid deduction in the case of REITs.

In response, the Action 2 report issued on Oct. 5, 2015 provides a specific exclusion from the definition of hybrid financial instrument for dividend payments that are deductible because of the status of the payor (in other words, dividends deductible in the U.S. or other countries because the payor is a REIT). As a result, a REIT dividend eligible for the dividends paid deduction are not considered to be a hybrid merely because of the dividends paid deduction.

Why Should the Special Circumstances of REITs Be Considered Here?

Unlike entities with significant intangible value, a REIT's "intangible" value is inseparable from the underlying tangible real property and as such, is not portable. Therefore, there is no intangible value to shift to other jurisdictions. And, there really is very little opportunity for U.S. REITs to "game" the system. Further, the country in which the real estate is located obtains substantial funds from the REIT or any of its subsidiaries through the levy of real property taxes.

In 2017, the U.S. tax system converted from one of worldwide taxation, on a deferred basis subject to controlled foreign corporation (CFC) rules, to a quasi-territorial system under which dividends from CFCs are excluded from U.S. taxation, but certain targeted income of CFCs is still subject to immediate taxation. In addition, the U.S. enacted its own form of a global minimum tax. Under the new tax regime, certain income became subject to tax as global intangible low-taxed income (GILTI). REITs are subject to GILTI inclusions with respect to their CFCs, but REITs are not allowed the GILTI deduction which is allowed for non-REIT Subchapter C corporations. As such, U.S. REITs are still taxed on a worldwide basis and are not beneficiaries of the current quasi-territorial system. This result helps support to the contention that U.S. REITs, in particular, should not be subject to the GloBE proposal as discussed below.

REIT Requirements

As noted, in order to avail themselves of their special tax status, U.S. REITs are subject to several, stringent ongoing tests and requirements, including income and asset tests, to ensure that the primary function of a REIT is the ownership and operation of real estate and that their ownership interests are widely held. The requirement and tests are broken down as follows:

- Organizational Requirements

- Quarterly Gross Asset Tests
- Quarterly Securities Tests
- Annual Gross Income Tests
- Annual Distribution Requirement

Organizational Requirements

A U.S. REIT must meet the following organizational requirements:

- It must be managed by one or more trustees or directors
- The beneficial ownership of the REIT must be evidenced by transferable shares
- It would otherwise be taxable as a domestic corporation but for its REIT status
- It is neither a financial institution nor an insurance company
- Its beneficial ownership is held by 100 or more persons
- It is not closely held (five or fewer individuals do not own more than 50% in value of its outstanding stock during the last half of the taxable year)

Quarterly Gross Asset Tests

- 75% Gross Asset Test – At least 75% of the value of the REIT's assets must consist of real estate, cash and cash items, and US government securities.
- 25% Gross Asset Test – Not more than 25% of the REIT's assets can be securities other than those that qualify for the 75% Gross Asset Test.
- 20% Taxable REIT Subsidiary (TRS)- Test – Not more than 20% of the REIT's assets can be securities of one or more TRSs. A TRS can conduct non-REIT activities other than operating or managing health care and lodging facilities and its income and assets are not subject to REIT

testing. TRSs are taxed as regular corporations (no dividends paid deduction) and are not subject to REIT distribution requirements. Likewise, dividends from TRSs that are passed through to REIT shareholders are taxed at the more favorable tax rates available to shareholders of non-REIT corporations.

Quarterly Securities Tests

A REIT's investment in non-TRS entities is even more limited:

- 5% Value Test – Not more than 5% of the value of the REIT's gross assets can be represented by the securities of any one issuer.

- 10% Voting Test – The REIT cannot own more than 10% of the outstanding voting securities of any one issuer.

- 10% Value Test – The REIT cannot own more than 10% of the total value of the outstanding securities of any one issuer.

Annual Gross Income Tests

- 75% Gross Income Test: At least 75% of a REIT's gross income must be derived from the following real property related sources:

    - Rents from real property

        - Interest on obligations secured by real property

        - Gain from the sale of real property

        - Dividends from other REITs

    - 95% Gross Income Test: At least 95% of REIT's gross income must be derived from real property related sources included in the 75% Gross Income Tests, as well as:

        - Interest income from any source

- Dividends from any source
- Gain from the sale or other disposition of any security

The Treasury Department and Internal Revenue Service have the authority to issue guidance as to whether other items of gross income qualify for the 75% and 95% Income Tests or whether they should be disregarded for purposes of calculating the Gross Income Tests.

Annual Distribution Requirement

- Generally, a REIT must distribute at least 90% of its taxable income annually, and, these distributions must be made in the current year or by January of the following year if certain conditions are met. Under special circumstances distributions can be "thrown back to a subsequent year. To avoid the imposition of excise taxes, a REIT must distribute at least 85% of its ordinary taxable income and 95% of its net capital gain.

In summary, the U.S. REIT rules require that a REIT's equity interests ultimately must be widely held. Their assets must be comprised of mostly real estate and their income must be rental real estate income. Since they must distribute substantially all of their taxable income, many REITs are more dependent on capital markets to raise money. Also, in order to conduct *non-real estate* activities, REITs must conduct these activities in TRSs and REITs cannot invest more than 20% of their overall value in TRSs. To the extent the TRS limit is exceeded, the activities and assets of the TRS must be brought into the REIT, subjecting those activities to REIT testing. While U.S. TRSs are already subject to U.S. taxation, foreign TRSs are not. As such, when the assets and activities of foreign TRSs are brought into the REIT, the taxable income generated thereby is subject to immediate taxation in the U.S. As such, under current rules, in the case of a U.S. REIT with international operations, much of its worldwide income is subject to immediate taxation in the U.S. under current law either through the CFC or GILTI rules or because the TRSs' assets are distributed to the REIT. Additionally, and as explained below, the U.S. tax is in addition to taxes incurred and currently paid in the real estate's country of residence.

Recommended Treatment for REITs

As noted in our Dec. 2, 2019 letter, the GloBE proposal contemplates two interrelated sets of rules allowing for the imposition of additional tax when income is subject to tax in the residence country at an effective rate below an agreed minimum rate of tax. The first set of rules would allow the *parent company's* country of residence (the residence country) to impose tax on income earned by a controlled foreign subsidiary or foreign branch that is not subject to tax at or above the minimum tax rate (the

income inclusion rule).[5] The second set of rules would allow the *payor company's* country of residence (the source country) to impose tax (by denying a deduction or imposing a withholding tax) when a payment made by that company is not subject to tax in the hands of the recipient at or above the minimum tax rate (the undertaxed payment rule).

As noted in our prior correspondence, REITs are not the intended target of GloBE. REIT assets primarily consist of real estate, with all of the value inherent in the real estate rather than in separate intangibles. Real estate by its nature has a fixed location, and, as such, its value is not portable with little risk to it being shifted to low tax jurisdictions. Consistent with the OECD's prior treatment of REITs, it would be appropriate for the special status of a REIT to be considered here. The foreign operations of a REIT typically are subject to taxation (including property-based taxes) in those countries where it is operating through subsidiary entities, and, in the case of the U.S. REIT, may be subject to tax under the GILTI rules and/or under the CFC ("subpart F") rules.

We are requesting that REITs receive an exemption from the proposed global corporate minimum tax. Our concern is not with tax being imposed by the REIT's residence country. The REIT's residence country has a vested interest in setting sound policy for entities domiciled within its jurisdiction. Our issue lies with the potential inappropriate application of minimum tax rules when a REIT receives a payment from a foreign subsidiary or when a REIT in one country holds a significant interest in a REIT organized in a different country. As noted above, the residence country has a vested public policy interest in allowing REITs to retain their special status in order to continue the promotion of widely held ownership of real estate as well as its development. Allowing a source country to impose a tax on a payment to a REIT would undermine and possibly thwart these policy objectives. If the payor country were allowed to impose a minimum tax on a REIT under the undertaxed payment rule by considering only the tax actually paid at the entity level and disregarding the structure of the REIT regime as a whole, then it would negatively impact the residence country's legitimate tax policy underlying the REIT regime. As noted above, although these payments are not subject to tax at the recipient REIT entity level, the income is distributed currently and individual shareholders are subject to tax on the dividends at a higher rate. Specifically, a U.S. REIT's individual shareholders are subject to tax at a rate 48% higher than the rate imposed on a non-REIT corporation shareholder (a dividend received by individual shareholder of a non-REIT U.S. corporation is subject to a tax rate of 20% while the same shareholder would be taxed at 29.6% on a distribution from a U.S. REIT).

Similarly, in the situation of a REIT organized in one country owning a significant interest in a REIT organized in a different country, the residence country of the parent REIT should not be allowed to impose a minimum tax on income of the second REIT under the income inclusion rule by considering

[5] Taxing Multinationals: The GloBE Proposal for a Global Minimum Tax, International Journal, January 10, 2020.

only the tax actually paid at the level of that REIT because that would interfere with the legitimate policy underlying the REIT regime of the residence country of the second REIT. As discussed above, although the income of the second REIT is not subject to tax at the entity level, the income is distributed currently and shareholders are subject to tax on such dividends on a current basis. Moreover, significant foreign shareholders of a U.S. REIT are subject to higher withholding taxes on REIT dividends under U.S. tax treaties than the withholding tax rate imposed on non-REIT corporation dividends paid to a significant foreign shareholder.

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Again, we welcome the opportunity to provide comments on this important issue. We would be happy to discuss these comments or to respond to questions or provide additional information that would be useful. Please contact me at tedwards@nareit.com or (202) 739-9408; Catherine Barre, Nareit's Executive Vice President & General Counsel, at cbarre@nareit.com or (202) 739-9422; or Dara Bernstein, Nareit's Senior Vice President & Tax Counsel, at dbernstein@nareit.com or (202) 739-9446, if you have any questions.

Respectfully submitted,

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