REALpac
Real Property Association of Canada | Association des biens immobiliers du Canada

Mr. Peter Godsoe
Chair
Advisory Panel on Canada's System of International Taxation
333 Laurier Avenue West, 15th Floor
Ottawa, ON
K1A 0G5

July 15, 2008

Dear Mr. Godsoe:

We are writing in response to the panel's consultation document, "*Enhancing Canada's International Tax Advantage*." We appreciate the opportunity to offer comments to the panel as they pertain to real estate.

We suggest the following for the panel's consideration:

1. OECD Recommendations on REITs

Global real estate associations, including REALpac, have been working with the OECD since 2006 to enable cross border investments by Real Estate Investment Trusts ("REITs"), now a global real estate investment vehicle. The point of the amendments was to ensure REIT distributions were taxed like dividends to foreigners, not rent. We would like Canada to adopt these provisions in its foreign tax treaties immediately, starting with the US, and all other countries with existing REIT structures (which would include the UK, Australia, Germany, France, The Netherlands, Japan, Hong Kong, and over 20 other countries). This would enable Canada's REITs to both attract foreign investment on a tax efficient basis, and to more readily invest in foreign countries.

Bilateral treaties containing these types of REIT-investment enabling provisions already exist between Australia and the United States (and we suspect, between Australia and many of its trading partners). We have attached as Schedule "A" a copy of the Organization for Economic Co-operation and Development (OECD) Model Tax Code excerpts regarding Real Estate Investment Trusts (REITs), in their recently released report. As a member of the working group that produced this document, we support the REIT taxation policies contained therein.

2. Foreign Accrual Property Income (FAPI)

We support the observations in KPMG's report entitled, *"Reforming Canada's International Tax System-KPMG's Perspective,"* May 30, 2008. Under the "more than five full-time employee test", the KPMG report advises that a controlled foreign affiliate that carries on a real estate development business must meet this test in order for its income not to be considered FAPI. It goes on to state that it is often not realistic for a small real estate development company to meet the test throughout the life cycle of a typical real estate development project. For example, the employee test could be met in the development phase but perhaps not in the sales/leasing phase, and vice versa. In such circumstances, KPMG concludes, and we agree, the test seems both arbitrary and contrary to a tax policy of assisting Canadians in exporting their entrepreneurial skills and expertise to foreign markets.[1]

The current test of considering only employees of the enterprise does not reflect commercial reality. Real estate activities are typically conducted through services of contractors and the current measure of activity is not appropriate for real estate.

3. Other Foreign Affiliate Issues

Canada's foreign affiliate regime is further complicated by technical and policy issues specific to real estate. For example, certain rules allow a foreign affiliate to "count" some services provided by employees of related foreign affiliates under certain circumstances. However, these rules are overly restrictive and often do not operate properly under accepted commercial operating structures inherent in a large real estate group of companies. In addition, CRA has apparently very strictly interpreted these rules so that their application is limited.

4. Limited Liability Companies

The most common US investment vehicle is the limited liability company (LLC). Canadian tax law views this entity as a corporation subject to the same foreign affiliate rules that apply to a regular corporation. However, we submit that US tax law views an LLC as fiscally transparent. This dual treatment creates problems for real estate enterprises in that the Canadian foreign affiliate system often fails to appropriately credit/recognize the US taxes paid on the underlying earnings as these are not paid by the LLC but rather by its member/shareholder.

[1] Source: KPMG, *"Reforming Canada's International Tax System-KPMG's Perspective,"* May 30, 2008

We ask that Canada’s international tax policies fully incorporate the realities of commercial real estate operations and encourage the panel to consider these suggestions as well as the attached OECD working group document. We would be pleased to meet with you at your convenience to discuss.

Yours truly,

Michael Brooks
Chief Executive Officer

About REALpac

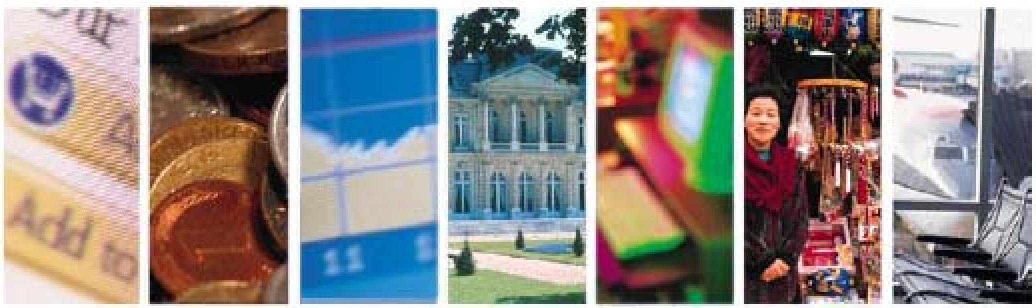
REALpac is Canada’s premier industry association for investment real property leaders. Our mission is to bring together the country’s real property investment leaders to collectively influence public policy, to educate government and the public, and to ensure stable and beneficial real estate capital and property markets in Canada.

Our Members currently own in excess of $150 Billion CAD in real estate assets located in the major centres across Canada. Members include real estate investment trusts, publicly traded and large private companies, banks, brokerages, crown corporations, investment dealers, life companies, lenders, and pension funds.

Schedule "A"
REIT Excerpts from the 2008 Update to the OECD Model Tax Convention
(pages 41-43)

OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



THE 2008 UPDATE TO THE OECD MODEL TAX CONVENTION

18 July 2008

Changes to the Commentary on Article 10

31. In paragraph 19 of the Commentary on Article 10, replace the cross-reference to "paragraph 53 of the Commentary on Article 24" by "paragraph *71* of the Commentary on Article 24".

32. 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".[7]

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. States 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 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

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

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. The State of source will therefore be able to tax such distributions to large investors regardless of the restrictions in subparagraphs a) and b).

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 organised 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 organised, 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 organised 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.