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THE REAL ESTATE INVESTMENT TRUST: A NEW MEDIUM FOR INVESTORS*

A. OVERTON DURRETT**

Introduction

In recent months, realtors, mortgage men, investors and attorneys have focused much attention on the possibilities afforded by the new provisions in the tax law approved on September 14, 1960, for the Real Estate Investment Trust (REIT).¹ Section 10(a) of P.L. 86-779 placed real estate on a par with the regulated investment companies (mutual funds). The tax advantage enjoyed by the mutual funds had allowed them to grow tremendously since the companies were not taxed on earnings distributed to shareholders if such companies meet the terms of Code § 851-855.² Meanwhile, the real estate trusts or similar organizations were taxed as corporations when in reality the only difference between them was in their source of income. (Realty and mortgage v. stock and securities)

The earnings statement of one of the nation's largest trusts, Real Estate Investment Trust of America, shows the effect of the new law:³

Earnings Statement (6 months ended Nov. 30, 1960)

	<i>Before Code § 856</i>	<i>After Code § 856</i>
Net Income (Before tax)	\$519,743.00	\$519,743.00
Federal Taxes	250,600.00	— 0 —
Net Income (Available for Shareholders)	\$269,143.00	\$519,743.00

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¹Section 10(a) of P.L. 86-779, 86th Cong., 2nd Sess., approved September 14, 1960.

²Int. Rev. Code of 1954.

³WALL STREET JOURNAL, March 2, 1961, p. 18, col. 6.

It can be readily ascertained that by allowing the Real Estate Investment Trust of America (if qualifications and limitations are met) the tax advantages given mutual funds, the Congress has given impetus to real estate investment that had previously been impeded by tax structure of the nation. Furthermore, several other advantages can be cited for the real estate investment trust:

1. Pooling of funds allows the small investor to undertake larger and more important investment projects. Through this means, private capital can be obtained for financing homes, apartments and office buildings, whereas now most real estate financing is dependent upon Government guaranteed money.
2. Diversification of assets affords more safety of investment.
3. Expert investment counsel can be retained. This will allow many potential investors who have funds available for investment to participate when they otherwise would not invest because of lack of time or money to seek out opportunities for investment.
4. Marketability of shares will be a definite advantage since previously many real estate syndicates limited the right to transfer shares. Since shares could not be traded freely, many investors were discouraged, but with the trust shares being easily transferred, the shares will be more valuable.⁴

The "Massachusetts" or business trust, the basic type of organization impliedly prescribed by the Code, has been recognized in this country since the 19th Century. Its failure to contribute substantially to the United States economy can be largely attributed to the early court decisions taxing it as a corporation. However, it is clear that mutual funds could not have grown to their present position in the economy if they had to pay one half of their income for taxes in addition to the costs of investment services for management as the real estate trust had to do previously.

Of course, tax advantages allowed Real Estate Investment Trusts by P. L. 86-779 are not given without stringent limitations so as to insure that the intended purposes will not be circumvented. The scope of this paper shall be to preview the effects

⁴H. Rep. No. 2020, 86th Cong., 2d Sess., pp. 3-4.

of these limitations on the real estate investment trust after a brief study of the history of this form of investment.

History of Taxation of Real Estate Trusts

Judicial:

The Revenue Act of 1909 — the ancestor of the corporate income tax — placed an excise tax of one percent of income on the privilege of doing business in a corporate form or in a quasi-corporate form. This Act required two basic areas of statutory interpretation, the first of which was: what types of entities were covered beside the corporate form? Since a 1910 case⁵ held that trusts were not "organized under the laws" and were accordingly not covered, this area did not give rise to uncertainty. However, the second question of when an entity was carrying on business did draw a great deal of careful consideration with a broad distinction being drawn by Mr. Justice Day in *Flint v. Stone Tracy Company*,⁶ and in *Zonne v. Minneapolis Syndicate*.⁷ The *Flint* case involved a number of real estate corporations joined with a corporation owning and leasing ore lands for rent or royalty. All of these companies engaged in investing operations as well as in operating them. Justice Day held these companies to be "carrying on business" as contrasted to the *Zonne* case which was held not taxable for it had "wholly parted with control-management of the property." The power of the corporation involved was limited by the corporation charter to holding a single piece of property under lease for 130 years and collecting and distributing rents to shareholders. Thus a distinction was drawn between corporations which did and did not engage in or control those activities which result in the production of income. This distinction remains in the tax laws of today.⁸

Following these two decisions the area of "twilight" was clouded with several cases⁹ which are now of only minor interest

⁵*Eliot v. Freeman*, 220 U.S. 178 (1910).

⁶220 U.S. 107 (1910).

⁷220 U.S. 187 (1911).

⁸Channing, *Federal Taxation of the Income of Real Estate Investment Companies*, 36 TAXES, 502, 505 (July 1958).

⁹*Crocker v. Malley*, 249 U.S. 223 (1919); *Hecht v. Malley*, 265 U.S. 144 (1924); *Burk-Waggoner Oil Assn. v. Hopkins*, 269 U.S. 110 (1925).

and which led to general confusion in the concepts until Mr. Justice Hughes wrote the opinion in *Morrissey v. Commissioner*.¹⁰ This case involved a trust created for the development of a tract of land through construction and operation of golf courses, clubhouses and residential areas. In conjunction with these activities it was to also conduct business with broad powers for purchases, operation and sale of property. Shares of beneficial interest were issued but the shareholders had only advisory power so that the trustees had almost unbridled discretion in the operation of the trust. The government, of course, contended that the trust was an "association" within the meaning of the Revenue Acts of 1924-1926 while the trustees claimed to be a strict trust as the beneficiaries had no control over the trustees. Mr. Justice Hughes distinguished between the strict and business trust by stating that in the former there is no "association" between the beneficiaries and trustees; and further, that while the purpose of the ordinary trust is conservation, the purpose of the association is to carry on business and make profit.

This case established three essential tests for determining whether an organization should be taxed as an association:

- (1) Two or more individuals associating themselves in a joint enterprise.
- (2) Enterprise should have resemblance to corporation.
- (3) Purpose of enterprise is carrying on business for profit.

It appears that all three of these elements are necessary for the organization to be classified as an association taxable as a corporation.¹¹

Legislative:

It was not until 1936 that the Treasury applied the rule in the *Morrissey* case to investment companies and taxed investment trusts as corporations whether of the *fixed* or *management* type.¹² This regulation led to litigation which resulted in 1941 in distinguishing between the fixed and the management types, holding

¹⁰296 U.S. 344 (1935).

¹¹Channing, *supra*, note 8 at p. 507.

¹²Treas. Reg. 86, Article 801.2.

the former where the trustee does not charge investments not taxable as a corporation and holding the latter to be taxable. It was *Commissioner v. North American Bond Trust*¹³ which fixed the law as it applied to securities investment trusts.

The statutory exemption from income taxes for the regulated investment companies under the Revenue Act of 1936 made it possible for these mutual funds to organize a trust for the purpose of providing expert centralized investment management without corporate tax liability. In contrast to ordinary corporations most investment companies enjoy freedom from taxation. Thus, the investment company shareholders are not burdened with an additional layer of taxes.¹⁴ Growth of the REIT was stymied because investors would not organize them since this type of venture would require twice the capital needed in organizing a regulated investment company or direct investment in real estate or securities in order to receive a given return. In the light of the spectacular growth of mutual funds, the need for a "conduit" to pass rents from property free of corporate taxes became apparent to many investors. Steps to eliminate the distinction between the tax consequences of dividends and interest as contrasted to rents were made initially in 1956 when identical bills¹⁵ were filed in Congress by Congressman Simpson of Pennsylvania and Congressman Keogh of New York. The main provisions of H. R. 4392 were that relief be extended only to trusts operating as investment conduits as distinguished from corporations operating in this manner. In paragraph § 856(b)(1) of the original bill it was required that the beneficial interest be held by twenty-five or more persons but was silent on the control of the trust and the possibilities of carrying on the business in an active capacity. An election to be treated as conduit by the trust was required. A favorable report filed by the House Committee stated the inconsistent tax treatment of securities income and rental income discriminated, without reason, against the real estate investment trust and impeded the flow of investment capital toward its "highest and best" use.¹⁶

¹³122 F. 2d 545 (1941).

¹⁴Weisenberger Investment Companies, p. 91 (1957); Channing, *supra* at note 8, p. 502.

¹⁵H.R. 4392 & H.R. 6264, 84th Con., 2d Sess., approved by House on July 23, 1956, and in Senate on July 26, 1956.

¹⁶Channing, *supra*, note 8, p. 511.

Several amendments were incorporated into the bill by the House Ways and Means Committee so as to limit the operations of these trusts in many ways. The first amendment increased the minimum membership of the entity to one hundred persons. Another important change prohibited the relationship between the trust and tenant from extending beyond that of landlord and tenant. The third, and perhaps the most important amendment, dealt with the extent to which a REIT could engage directly in the production of income. In order to more fully define the "passiveness" of the trust the Committee amended the bill to exclude from rents any income received from property with respect to which the trust made any expenditure other than those "properly chargeable to capital account." Under the newly amended bill a REIT could not derive more than 10% of its income from "operated" properties.¹⁷

This amended bill was passed by both Houses of Congress and sent to the President who subsequently vetoed it. He felt compelled to explain his reasons for vetoing and set the reasons forth in the following memorandum:

... While the bill assumes a similarity between real estate trusts and regulated investment companies, there are important differences between the two situations. The income of regulated investment companies is generally derived from the securities of corporations which are fully subject to corporate income tax. In the case of regulated investment companies, therefore, the conduit treatment merely avoids an additional level of corporate taxation, which for divided income consists of the tax on the portion of dividend remaining after the 85% intercorporate dividends deduction. By contrast, the conduit treatment proposed for real estate trusts would entirely remove the corporate income tax from much of the income originating in their real estate operations.

It is by no means clear how far a new provision of this sort might be applied. Though intended to be applicable only to a small number of trusts, it could, and might well become, available to many real estate companies which were originally organized and have always carried on their activities as fully taxable corporations.

¹⁷*Ibid.*, p. 512.

For these reasons, I am constrained to withhold my approval of the bill.¹⁸

President Eisenhower's veto apparently was based on two reasons: (1) He felt that real estate was not subject to the "triple tax" to which mutual funds would be subject if not for this special treatment; (2) Loss of revenue to the government.

At the first session of the 85th Congress, the House of Representatives again initiated and subsequently passed a similar measure.¹⁹ After the passage in the House, the Senate did not take independent action on this bill but incorporated it into the bill which ultimately was adopted as the Technical Amendments Act of 1958.²⁰ Before this act was enacted, however, the proposal as to real estate investment trusts was deleted by the Conference Committee.²¹

Again in the 86th Congress, Congressman Keogh sponsored a similar bill which was approved by the House.²² The Senate instead of handling separately incorporated it as Amendment No. 9 into a bill dealing with a number of miscellaneous tax matters.²³ It was in this form that the measure was finally adopted by the Senate and received the subsequent approval of the President. An interesting note on politics arises out of this bill since the measure approved by President Eisenhower has essentially the same structure as the bill vetoed in 1956. Apparently the main reason for the change of attitude by the President lies in the economic condition of the country at that time and the pressing need for private investment capital.

¹⁸Messages of President Eisenhower, dated August 10, 1956, 84th Con., 2d Sess.; U. S. Code Congressional and Administrative News, vol. 3, p. 4826 1956.

¹⁹H.R. 8102, 85th Cong., 1st Sess., approved July 31, 1957.

²⁰H.R. 8381. Enacted as Title I of P.L. 85-866, 85th Cong., 2d Sess., approved September 2, 1958.

²¹Sen. Rept. #1983, 85th Con., 2d Sess., p. 65 at 192; H. Rep. #2632, 85th Cong., 2d Sess., p. 30.

²²H.R. 12559, 86th Cong., 2d Sess., approved January 29, 1960.

²³H.R. 12559 became § 10 of H.R. 10960 by a Senate floor amendment.

Real Estate Investment Trusts Under The New Law
Definition:

In a statute of this nature the definition of the terms utilized in the Code are extremely important. The statutory definition must be followed in order to insure the qualifications of the trusts within the framework of the Code.

The term "trust" is open to several meanings since it is not always used in its technical sense. Sometimes it serves merely to indicate a fiduciary relationship but since many times the business "association" called trusts have been taxed as corporations, it is necessary to have standards defined in the Code. The term "real estate investment trusts"²⁴ means an unincorporated trust or an unincorporated association with these added criteria:

- 1) Management of the trust must be in the hands of one or more trustees.²⁵
- 2) Beneficial ownership is evidenced by transferable shares or by transferable certificates of beneficial interest.²⁶
- 3) Organization is of the type that would be taxed as a corporation except for the provision relative to REIT.²⁷
- 4) No property may be held primarily for sale to customers in the ordinary course of business.²⁸ (This restriction was placed here to assure that the organization does not engage in an active business enterprise.)²⁹
- 5) Beneficial ownership must be held by at least one-hundred persons, including individuals, trusts, estates, partnerships, associations, companies or corporations.³⁰ No "attribution" rules are applied in this instance so as to reduce the

²⁴IRC (1954) § 856(a).

²⁵IRC (1954) § 856(a)(1).

²⁶IRC (1954) § 856(a)(2).

²⁷IRC (1954) § 856(a)(3).

²⁸IRC (1954) § 856(a)(4).

²⁹H. Rep. #2020, 86th Cong., 2d Sess., p. 5.

³⁰IRC (1954) § 856(a)(5).

number of effective holders considered to be present,³¹ but these required one-hundred owners must hold shares during at least 335 days of a taxable year of twelve months or during a proportionate part of a taxable year of less than twelve months.³²

- 6) The organization can not be a personal holding company under § 542 even if all its gross income was personal holding company income under § 543 of the Code. In other words, it may not be more than 50% owned directly or indirectly by or for five or fewer individuals. In this case, however, the statutory attribution rules of § 544 are applicable.

Note: The first four of the above requirements must be met during the entire taxable year.³³

Other important definitions for the study of these sections are:

Value — means with respect to securities for which market quotations are readily available, the value of such securities; with respect to other securities and assets, fair value as determined in good faith by the trustee except that in the case of securities of real estate investment trusts such fair value shall not exceed market value or asset value, whichever is higher.³⁴

Real Estate Assets — “means real property (including interests in real property and investments in mortgages or real property) and shares (or transferable certificates of beneficial interest) in other real estate investment trusts which meet the requirement of this part.”³⁵ Under the proposed regulation the terms include leasehold mortgages but not the following items though classified as fixtures by state law: machinery, printing presses, equipment, refrigerators, individual air conditioners, grocery counters, motel, hotel and office furnishings.³⁶ Therefore, rents from a furnished

³¹Roberts, Feder & Alpert, *Congress approves real estate Investment Trust; Exacting Rules Made*. THE JOURNAL OF TAXATION, p. 194 (October 1960).

³²IRC (1954) § 856(b).

³³IRC (1954) § 856(b).

³⁴IRC (1954) § 856(c)(6)(A).

³⁵IRC (1954) § 856(c)(6)(B).

³⁶Proposed Treas. Reg. § 1.856-3(d), 26 Fed. Reg. 606 (1961).

building do not include that portion of rent allocable to furnishings.³⁷

Interests in Real Property — includes fee ownership and co-ownership of land or improvements thereon and leaseholds of land or improvements thereon, but does not include mineral, oil or gas royalty interests.³⁸

Qualified Real Estate Investment Trusts — a real estate investment trust within the meaning of Part II of subchapter M which is taxable under the provisions applicable to such organizations.³⁹

Partnership Interest — a trust which is a partner is deemed to own partnership assets in proportion to its capital interest. Rents from the real property owned by the partnership can be counted as real property rentals under the income test. However, it is well to note that a trust can be disqualified if it owns an interest in the partnership which holds property primarily for sale to customers.⁴⁰

Any other terms utilized shall have the same meaning as when used in the Investment Company Act of 1940 as amended.⁴¹

Elections:

Even though a trust or association satisfies the other requirements of § 856-858 for the taxable year, it will not be taxed as a REIT unless it elects to be taxed as such for the current taxable year or has made an election for a previous taxable year effective after December 31, 1960.⁴² Thus once having made an election the trust or association will be considered as such for every year it meets the requirements.

³⁷Proposed Treas. Reg. § 1.856-4(a), 26 Fed. Reg. 607 (1961).

³⁸IRC (1954), § 856(c)(6)(C).

³⁹Proposed Treas. Reg. § 1.856-3(f), 26 Fed. Reg. 607 (1961).

⁴⁰*Ibid.*

⁴¹IRC (1954), § 856(c)(6)(d).

⁴²IRC (1954), § 856(c)(1).

This election is irrevocable even with the consent of the Commissioner.⁴³ Of course, as in the case of Subchapter S, a trust can disqualify itself in a particular year by failing to satisfy any one of the prerequisites for the trust. An appropriate example is: Redemption of sufficient interests to reduce the number of beneficiaries to fewer than one-hundred would disqualify the trust. However, if in the subsequent year the number of beneficiaries exceeds one-hundred for the required number of days, the original election would again become effective.⁴⁴

A similar election provision requiring a regulated investment company to make an election is contained in Code § 851(b)(1). These regulations further state that the election must be made by the taxpayer by computing income as a regulated investment company in its return for the first taxable year for which the election is applicable. The proposed regulations⁴⁵ for REIT are very similar and it is anticipated that they will ultimately be enacted into law.

Gross Income Requirements:

Of all the limitations placed on the real estate investment trust the most exacting rules relative to qualification of the trust have been placed on the source of income. In order to qualify as a REIT three tests of gross income must be met. The three tests are:

1. 90% Test⁴⁶
2. 75% Test⁴⁷
3. 30% Test⁴⁸

⁴³Proposed Treas. Reg. § 1.858-1(b)(2), 26 Fed. Reg. 611 (1961).

⁴⁴Robert, Feder & Alpert, pp. 195-197. *Supra* note 31.

⁴⁵Proposed Treas. Reg. § 1.858-1(b)(2), 26 Fed. Reg. 611 (1961).

⁴⁶IRC (1954), § 856(c)(2).

⁴⁷IRC (1954), § 856(c)(3).

⁴⁸IRC (1954), § 856(c)(4).

(1) 90% Test —

Dividends,⁴⁹ interest,⁵⁰ rents from real property,⁵¹ gain from sales or other disposition of stock, securities and real property and interest in mortgages on real property,⁵² or abatement and refunds of taxes on real property⁵³ must account for at least 90% of the gross income of the trust. This provision is similar to the 90% test provided for the regulated investment companies, except for the addition of the various types of income derived from real property.⁵⁴ Consequently, a maximum of 10% of the gross income of the trust is not restricted as to source.⁵⁵

(2) 75% Test —

Under a second test, at least 75% of the trust's gross income must come from realty rents, interest on mortgages, gain from sale of realty, dividends or distribution on and gain from sale or disposition of shares of other REIT and abatements and refunds of taxes on real property.⁵⁶

This interaction of the 90% test and the 75% test requires that at least 75% of the trust's gross income come from real estate sources and that another 15% of its gross income be derived from either real estate or investments in stock, securities or mortgages. In contrast, the regulated investment companies are required to obtain 90% of their gross income from stock, so obviously there is no comparable 75% test for these companies.

(3) The 30% Test —

This third limitation is an effort to exclude organizations engaged in an active trading business and to prohibit use of the trust as a base for speculation. Under this provision the gross

⁴⁹IRC (1954), § 856(c)(2)(A).

⁵⁰IRC (1954), § 856(c)(2)(B).

⁵¹IRC (1954), § 856(c)(2)(C).

⁵²IRC (1954), § 856(c)(2)(1).

⁵³IRC (1954), § 856(c)(2)(E).

⁵⁴IRC (1954), § 851(b)(2).

⁵⁵Proposed Treas. Reg. § 1.856-2(c)(iii)(b), 26 Fed. Reg. 605 (1961).

⁵⁶IRC (1954), § 856(c)(3).

income of the organization derived from the sale or disposition of (a) stock or securities held for less than six months and (b) real property (including real property interests) held less than four years, must account for less than 30% of the trust's total income.⁵⁷ However, real estate or interests therein involuntarily converted within the meaning of § 1033 are not included within this 30%.⁵⁸ On the basis of the Committee report it was thought that for the purpose of the 30% Test, losses were not netted with gain.⁵⁹ However, the proposed regulations⁶⁰ state specifically that the loss is not to be netted with gain for the purposes of determining the numerator in the 30% rule only and further adds that the determination of the period for which the property has been held shall be governed by § 1223.

Regulated investment companies are subject to similar limitations.⁶¹ Under those provisions the mutual funds are required to have less than 30% of their gross income from the sale or disposition of stock or securities held less than three months.

The principal source of income includible under both the 90% and 75% tests is "rents from real property" defined⁶² as "including rents from interests in real property but does not include:"

(1) Amounts received or accrued which are geared wholly or partially to income or profit derived by any person from such property. If, however, the rent is based on a fixed percentage or percentage of sales receipts, the amount is includible as rent.⁶³

An example of the application of this rule is: "Where the fixed rental is agreed to and the agreement also calls for a percentage of the lessee's net profit in excess of a specific amount (usually determined before deducting the fixed rental and some-

⁵⁷IRC (1954), § 856(c)(4).

⁵⁸IRC (1954), § 856(c)(4)(B).

⁵⁹H. Rep. #2020, 85th Cong., 2d Sess., p. 9.

⁶⁰Proposed Treas. Reg. § 1.856-2(c)(2)(V).

⁶¹IRC (1954), § 851(b)(3).

⁶²IRC (1954), § 856(d).

⁶³IRC (1954), § 856(d)(1).

times called "overage rents"), neither the fixed rental nor the additional amount will qualify as 'rents from property.'"⁶⁴

(2) Amounts received or accrued directly or indirectly from any person if the trust owns (a) stock comprising 10% of the combined voting power of all classes of stock entitled to vote or 10% of the total number of shares of all classes of stock of such person or (b) if not a corporation, an interest of 10% in the assets or net profits of such person.⁶⁵ "For example, a trust leases an office building to a tenant for which it receives rent of \$100,000 for the taxable year 1962. The lessee of the building subleases space to subtenants for which it receives gross rent of \$500,000 for the year 1962. One of the subtenants is a corporation in which the trust owns 15% of the total combined voting power of all classes of stock entitled to vote. The rent paid by this subtenant for the taxable year is \$50,000. Therefore, \$10,000 ($50,000/500,000 \times 100,000$) of the rent paid to the trust does not qualify as 'rents from real property.'"⁶⁶

(3) Amounts received or accrued where the trust furnishes or renders services to the tenants other than through an independent contractor. An independent contractor for this purpose means (a) a person who does not own, directly or indirectly, more than 35% of the shares of the trust or (b) if a corporation not more than 35% of total voting power of whose stock is owned directly or indirectly by one or more persons owning 25% of the shares of the trust.⁶⁷ Services which must be rendered the tenant by the independent contractor in order to avoid disqualifying the rent include: hotel, motel, janitor, elevator, telephone switchboard, guard and similar services. Deductible repairs and maintenance must also be paid for and controlled by the contractor. On the other hand, the trustee is allowed to perform the following functions: establish rental terms, choose tenants, enter into and renew leases, handle taxes, interest and insurance and make capital expenditures.⁶⁸

⁶⁴Proposed Treas. Reg. § 1.856-4(b)(1), 26 Fed. Reg. 607 (1961).

⁶⁵IRC (1954), § 856(d)(2).

⁶⁶Proposed Treas. Reg. § 1.856-4(b)(2), 26 Fed. Reg. 607 (1961).

⁶⁷IRC (1954), § 856(d)(3).

⁶⁸Proposed Treas. Reg. § 1.856-4(b)(3), 26 Fed. Reg. 607 (1961).

These three restrictions on the "rents" were imposed to insure that such income inures from passive sources rather than from the active conduct of a trade or business in real estate. With these types of safeguards there is little possibility of the trust benefitting from the income derived from the active management of property.

Investment Requirements:

Each quarterly closing of the trust's books requires that the trust comply with two restrictions in order to qualify.

1. At least 75% of the value of the trust's total assets must be represented by the real estate assets, cash and cash items and Government securities.⁶⁹

2. Not more than 25% of the total value of the trust's assets may be invested in securities other than those mentioned above. A further limitation states that the trust investment in one issuer's stock may not be greater in value than 5% of the value of the total assets of the trust and may not be more than 10% of the issuer's outstanding voting securities.⁷⁰ Diversification of investment is the objective of this test. An example of a trust failing to qualify because of lack of diversity would be:

Cash	5%
Gov. securities	10%
Real estate	65%
Corp. A stock	8%
Corp. B stock	12%
	<hr/>
	100%

This trust fails to qualify since its investment in the stock of each corporation A and B exceed 5% of the total assets of the trust at the close of the quarter.

Although the investment percentage requirements must be met at the close of each quarter of the taxable year, provisions have been made to prevent disqualification as the result of mere fluctuation in market value and to permit curing of transitory

⁶⁹IRC (1954), § 856(c)(5)(A).

⁷⁰IRC (1954), § 856(c)(5)(B).

disqualifications.⁷¹ Thus a trust that meets the percentage requirement at the close of any quarter will not become disqualified because of failure to meet them in a subsequent quarter unless such failure exists immediately after an acquisition and is the result of such acquisition. Moreover, if the disqualification occurs as the result of an acquisition in a particular quarter, the trust will not be disqualified if the discrepancy is eliminated within 30 days after the close of such quarter.⁷²

Another area which will be important in computing whether or not a trust qualifies for the real estate trust tax treatment will be the value placed on the assets of the trust. Determination of the real estate value is the fair value placed on them in good faith by the trustees so that difficult appraisals and computations will not be required at the time of acquisition of the property. However, one question has not been answered by the Code or regulations. It arises when the trustee acquires mortgages on real estate since there is no criterion as to whether the value should include the amount of the mortgage or is limited to the equity. Argument can be made on both views. Full value of the real estate could be a measure since the entire property is producing income and more clearly measures the extent of the investment. The net value concept has merit on the ground that only the amount of funds actually received from shareholders and invested should measure the extent of investment. In any event, this particular requirement on the asset apportionment will be important since the value of non-real estate assets can be higher if the value of real estate includes the mortgage so the final conclusion on this problem will be a determining factor in the composition of the trust investment.⁷³

Taxation of REIT — Beneficiaries Under New Law

Taxation of Trusts:

Election and qualification of a trust as a REIT does not automatically entitle the trust to conduit treatment. Trusts are basically 'associations' taxable as corporations⁷⁴ with their ordinary

⁷¹Robert, Feder & Alpert, pp. 194-195. *Supra* note 31.

⁷²IRC (1954), § 856(c)(5).

⁷³Research Institute of America, § E-7004, ¶. 21,014 (1961).

⁷⁴IRC (1954), § 7701(a)(3).

income subject to the corporate normal and surtax rate of 30% and 22% respectively.⁷⁵ Failure to distribute 90% of the ordinary income⁷⁶ (computed without regard to capital gain dividends) or to meet other requirements⁷⁷ will cause the entire income of the REIT trust to be taxed as opposed to the tax only on retained ordinary income if the 90% rule is met. For the purpose of computing the "real estate investment taxable income," the following adjustments to taxable income must be made:

1. Excess of net long-term capital gain over the net short-term capital loss is excluded. (Capital gains are taxed separately).⁷⁸

2. Deduction for corporations provided in § 241-§ 247 (dealing with partially exempt interest and certain dividend received or paid) are not allowed.⁷⁹

3. Deduction for dividends paid and computed under § 561 shall be allowed without regard to capital gain dividends.⁸⁰

4. Taxable income shall be computed without regard to § 443(b) (relating to computation of the tax on change of annual accounting period).⁸¹

5. Net operating loss deduction provided in § 172 shall not be allowed.⁸²

After the adjustments to taxable income have been made, it becomes apparent that the 90% rule may cause considerable difficulty if the trust's taxable income is greater than its net cash receipts, i.e., where mortgage principal payments exceed the annual depreciation allowance. At this stage the trust may have difficulty securing cash to distribute under the 90% rule. One solution would be to refinance the mortgage or to sell the property and reinvest the proceeds. The problem arises in the latter situa-

⁷⁵IRC § 11 (1954).

⁷⁶IRC (1954), § 857(a)(1).

⁷⁷IRC (1954), § 857(a)(2).

⁷⁸IRC (1954), § 857(b)(2)(A).

⁷⁹IRC (1954), § 857(b)(2)(B).

⁸⁰IRC (1954), § 857(b)(2)(C).

⁸¹IRC (1954), § 857(b)(2)(D).

⁸²IRC (1954), § 857(b)(2)(E).

tion where, if the property is greatly appreciated in value, the trust would realize a capital gain on the sale which if not distributed will be taxed both to the trust⁸³ and later to the beneficiaries.⁸⁴ A possible solution might be for the trust to declare an optional stock dividend of the gain in the manner used in many cases by the regulated investment companies.⁸⁵

There is one exception to the absolute fatalness of the failure to meet the 90% distribution requirement. The current earnings and profits of a trust (but not the accumulated earnings and profits) are not reduced by any amount which is not deductible in computing the organization's taxable income for the year. This applies even though the trust was not qualified for special tax treatment.⁸⁶ For example, if a trust had no accumulated earnings or profits but had rental income of \$100,000 and a capital loss of \$100,000, a distribution of \$50,000 normally would not be a dividend because not made out of earnings and profits. However, in the case of the trust, the capital loss does not reduce current earnings and profits so the distribution is considered a dividend. On the other hand, if the trust had failed to meet the 100 beneficiary requirement, it would not be subject to the provisions of Subchapter M and the special rule for determining earnings and profits so the dividend would not be a dividend.⁸⁷

Even though an attempt is made to give these distributions special consideration, capital gains treatment in the real estate investment trust is different for those gains may be taxed twice under some circumstances. Undistributed long term capital gains (excess of long term capital gain over the short term capital loss with a deduction for dividends paid determined with reference to capital gains dividend only)⁸⁸ is taxed at a flat 25% rate. This provision certainly does not benefit the beneficiaries since this

⁸³IRC (1954), § 857(b)(3)(A).

⁸⁴IRC (1954), § 857(b)(3)(C).

⁸⁵Roberts, Feder & Alpert, *Federal Taxation of the Income of the Real Estate Investment Company*, pp. 194, 198, THE JOURNAL OF TAXATION (October 1960).

⁸⁶IRC (1954), § 857(d).

⁸⁷Roberts, *Id.* at note 85.

⁸⁸IRC (1954), § 857(b)(3)(A).

gain is taxed again to them when distributed. However, the distributed capital gains are not taxable to the trust but are passed on to the distributee where it is taxed only once as a capital gain.

Another feature allows dividends paid by the organization after the close of the year to be treated as having been paid during that year. This provision is applicable only if the following conditions are met: (a) Trust must declare the dividend before the time prescribed for filing its return for the year to which the dividend is to be "thrown back." The time allowed is extended by each extension allowance for the filing of the return.⁸⁹ (b) Dividend must be paid during twelve month period following the end of the year to which thrown back but in no case shall it be later than the date of the first regular dividend payment. (c) The provision also requires that any notice required to shareholders or other interest holders in regard to dividends shall be given not later than thirty days after end of taxable year in which distribution is made.⁹⁰ (d) An election to "throw back" must be made in the organization's returns for the year to which the dividend is to be shifted and this apparently means a partial "throwback" also.⁹¹

The effect of these provisions is to treat the trust as a conduit for the distribution of income to the beneficiaries with the least tax consequences. However, there is one feature of the real estate trust law which will cause some trusts concern when they have a net loss from their operations. Such a loss is apparently wasted since the trust cannot use it as a net operating loss carry-over or carryback in computing its real estate investment trust taxable income and there is no provision for passing losses through to the shareholders for use on their individual returns.⁹²

Taxation of Beneficiaries:

Holders of certificates of the REIT are required to handle the "real estate investment trust taxable income" distributed to them as ordinary income. Since these distributions are not

⁸⁹IRC (1954), § 858(a)(1).

⁹⁰IRC (1954), § 858(c).

⁹¹IRC (1954), 858(a), cf. Reg. 1.855-1.

⁹²Research Institute of America, § E-7100, ¶ 21,014 (1961).

considered to be dividends, the beneficiaries of the fund get no 4% dividend-received credit,⁹³ nor are such distributions subject to the \$50 exclusion,⁹⁴ or to the dividends-received deduction allowed corporations by § 243.⁹⁵

The principal exception to the ordinary income treatment of distribution from the trust relates to the so-called "capital gains dividend." This capital gains dividend is "any dividend, or part thereof, which is designated by the real estate investment trust as a capital gain dividend in a written notice mailed to its shareholders or holders of beneficial interests at any time before the expiration of thirty days after the close of its taxable year."⁹⁶ If the aggregate amount so designated with respect to the taxable year of the trust (inclusive of capital gain dividends "thrown back" under § 858) is greater than the excess of the net long term capital gain over its short term capital loss for the year, then only a portion of the distribution is treated as a capital gain dividend. The portion is determined by applying, to the aggregate amount designated in the written notice, the ratio which the excess of actual net long term gain or net short term loss becomes to the aggregate designated amount.⁹⁷ Then the beneficiary pays the tax on the capital gain dividend just as any other long term gain.⁹⁸ However, unlike the case with the regulated investment companies,⁹⁹ there is no provision in the new law for taxing shareholders on the undistributed capital gains. Under these circumstances the trust is taxed on such gains and the shareholder is taxed later on the same gain when distributed.

To eliminate tax avoidance possibilities in converting short term into long term capital gain, the statute provides, where the stock or interest has been held by taxpayer for less than 30 days prior to the distribution of the gain dividend, any loss on the sale or exchange of such stock or interest is treated as long term capital

⁹³IRC (1954), § 34(a).

⁹⁴IRC (1954), § 116.

⁹⁵IRC (1954), § 857(c).

⁹⁶IRC (1954), § 857(b)(3)(c).

⁹⁷IRC (1954), § 857(b)(3)(C).

⁹⁸IRC (1954), § 857(b)(3)(B).

⁹⁹IRC (1954), § 857(b)(3)(D).

loss to the extent of the capital gain dividend.¹⁰⁰ Regulated investment companies beneficiaries are subject to a similar provision designed to curb tax avoidance.¹⁰¹ In determining whether or not the stock or interest has been held for less than 30 days, the rules of § 246(c)(3) applicable to the dividends received deduction are applied.¹⁰²

Under the provisions of § 858(b) (discussed in previous section) the beneficiaries are considered as having received the distribution of trust income in the year in which it was actually received. This is of course contra to the handling of the distribution by the trust.

Miscellaneous Provisions

Records:

A real estate investment trust is required to maintain records which will disclose the actual ownership of its outstanding stock.¹⁰³ The proposed regulations have set forth provisions for records similar to those required for regulated investment companies.¹⁰⁴

For the purpose of determining whether a company is a personal holding company, the trust's permanent records must show the maximum number of shares to be considered as actually or constructively owned by each of the actual owners of the stock at any time during the last half of the taxable year.¹⁰⁵

Liquidation:

Since a real estate investment trust would be taxed as a corporation except for the rules of § 856-858, the rules applicable to corporate liquidation also apply to the liquidation of such trusts. Amounts distributed in complete liquidation of a corporation are treated as full payment in exchange for the stock under § 331. Liquidation distribution by a real estate investment trust

¹⁰⁰IRC (1954), § 857(b)(4).

¹⁰¹IRC (1954), § 857(b)(4).

¹⁰²IRC (1954), § 246(c)(3).

¹⁰³IRC (1954), § 857(a)(2).

¹⁰⁴Treas. Reg. § 1.852-6 (1954).

¹⁰⁵Proposed Treas. Reg. § 1.857-6, 26 Fed. Reg. 610 (1961).

are, therefore, subject to the capital gain and loss provisions. Amounts distributed in partial liquidation are treated as being in part or in full payment in exchange for the shares or beneficial interest, and gain or loss is treated as capital gain or loss.¹⁰⁶

State Laws:

The relationship existing between the federal fiscal system and the laws of the states has been aptly phrased by Judge Learned Hand:

It is of course true, as the taxpayers argue, that the federal fiscal system is self-determined in the sense that the meaning of its terms does not depend upon the law of the state, nevertheless, when Congress imposes taxes based upon the existence of legal rights or duties, it must be understood to refer to such rights and duties as the state law creates, since there are no others; nor could there be, unless Congress were to set up for its fiscal use systems of municipal law parallel with those already existing in the state.¹⁰⁷

There being no system of federal municipal law, property rights fall almost exclusively within and are dependent upon the laws of the states, arising in connection with trusts where this is especially true of tax questions. The incidents of it are wholly dependent upon local law.

A study of the Code of Virginia (1950) sheds little light on the question of whether an unincorporated association meeting the requirements of a REIT can validly exist in the Commonwealth. There are no Code provisions such as found in New York which does not allow the shares of the beneficiary of an express trust to be transferred by assignment,¹⁰⁹ or which prohibit the trustee of a passive trust from holding title to real property.¹¹⁰ Provisions such as these are a major obstacle to the utilization of this form of investment in that state. The one area that might preclude the trustee in his fiduciary capacity from investing in real estate would be § 26-40,¹¹¹ since under this section real

¹⁰⁶CCH, Real Estate Investment Trust Booklet, p. 14 (1960).

¹⁰⁷Johnston v. Helvering, 141 F. 2d 208, 210, 32 AFTR 280 (CA 2 1944).

¹⁰⁸Merten's, LAW OF FEDERAL INCOME TAXATION, § 61.08.

¹⁰⁹N. Y. Prop. Law § 103.

¹¹⁰N. Y. Prop. Law § 93.

estate is not considered a lawful investment. Even here case law relieves the trustee from liability if he invests in property outside the qualified list and a loss occurs in spite of the fact that he exercises proper care and caution.¹¹²

In addition to the registration of the REIT under the Securities Act of 1933¹¹³ and the Investment Company Act of 1940,¹¹⁴ many states including Virginia will require registration of the shares under the state "Blue Sky Law."¹¹⁵ The term "security" under the state Securities Act is defined to include "any type of transferable share or any interest known as a security."¹¹⁶ Since the law pertaining to the real estate investment trust requires that shares be transferable, it is evident that the beneficial interests of the trusts will require registration.

State Court Adjudications:

Generally speaking, the Federal government taxing authorities are bound by state court adjudication affecting rights in the particular property.¹¹⁷

Apparently the Supreme Court of Virginia has been called upon only once to define the limitation upon the use of trusts within the state. In that instance the court quoting *Scott on Trusts* (vol. 1, p. 1, § 1.):

... A trust can be created for any purpose which is not illegal, which is not against public policy. ... The uses of the trust, however, go far beyond the effecting of family settlements. The trust has been frequently employed in business transactions. As Professor Isaacs has said: "Trusteeship has become a readily available tool for everyday purposes of organization, financing, risk, shifting, credit operation, settling of disputes and liquidation of business affairs." He also points out that 'modern business has become honey-combed with

¹¹¹Va. Code (1950).

¹¹²*Powers v. Powers*, 174 Va. 164, 3 S.E. 2d 162 (1939).

¹¹³15 U.S.C. § 77a-77aa (1952).

¹¹⁴15 U.S.C. § 80a-2 et seq. (1952).

¹¹⁵Va. Code (1950), § 13.1-501 to § 13.1-527.

¹¹⁶Va. Code (1950), § 13.1-501.

¹¹⁷Nossaman, *TRUST ADMINISTRATION & TRUSTS*, § 37-02.

trusteeship. Next to contract, the universal tool, and incorporation, the standard instrument of organization, it takes its place wherever the relations to be established are too delicate or too novel for these coarser devices.¹¹⁸

By this quote the Virginia Court has apparently given its approval to the use of the "trust" for use beyond the scope of family trusts so there is no reason to believe that a real estate investment trust could not function within the state.

Conclusion

In the interest of a sound tax structure, it is imperative that tax exempt entities be confined in their activities to passive investment media. Real estate investment trusts have been defined so as to preclude them from functioning in an active business area capacity. These provisions do not allow the trusts to undertake the obligation inherent in carrying on business. The limitations further remove the possibility of these entities expanding their operations so as to grow into monopolies of economic power.

The effect of these provisions is to treat the trust as a conduit since the trusts' distributed income is not subject to tax and distributed capital gains are "passed through" to the beneficiaries. However, the trust is not a true conduit for the trust is taxed on undistributed income and net operating losses are not "passed through" to the beneficiaries. Although these provisions may not be as advantageous as investors anticipated, they will place real estate investment in a competitive position and the financial circuit anticipates more capital for investment to become available for larger projects.

Public reaction to the new investment medium is uncertain at best but based on the success of the mutual fund and the general public investment attitude, the real estate investment trust is almost certain to make a tremendous impact on the investment field. This expected enthusiasm is borne out by a *Wall Street Journal*¹¹⁹ article stating: "Greenfield Real Estate Investment Trust's 500,000-share (\$10 million) offering was oversubscribed and the books closed soon after it reached the market." This may well be an omen.

¹¹⁸*Collins v. Lyon*, 181 Va. 230, 24 S.E. 2d 572 (1943).

¹¹⁹WALL STREET JOURNAL, March 30, 1961, p. 17, col. 8.