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Real Estate Investment Trusts: Problems and Prospects

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REAL ESTATE INVESTMENT TRUSTS: PROBLEMS AND PROSPECTS†

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I. Introduction

IT would seem logical that entities engaging in essentially the same activities should be taxed essentially the same—that the choice of business form should not affect taxation and, in reverse, taxation should not affect the choice of business form.[1] Yet, this is not so. The Internal Revenue Code has been characterized, in this regard, as a "crazy-quilt of exceptions, exemptions, deductions and special provisions."[2] In altering business entity taxation, special provisions have been made for regulated investment companies,[3] common trust funds,[4] partnerships,[5] cooperatives,[6] life insurance companies,[7] mutual savings banks,[8] and mutual fire and casualty insurance companies.[9] In addition certain corporations may elect to be treated as if they were not corporations,[10] and certain other business enterprises may elect to be taxed as if they were corporations.[11]

The most recent manifestation of Congress' sporadic interest in relief of entity taxation is the real estate investment trust legislation, enacted in 1960 as an addition to the 1954 Code.[12] As a result, real estate investment trusts complying with sections 856 through 858 of the Code are granted a deduction from corporate tax for dividends paid, including a capital gains "pass-through."[13] The writer submits that under present circum-

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1. The tax laws "must accord the same tax treatment to what is essentially the same type of operation irrespective of the form in which it is cast." Address by Representative Mills, in Kilpatrick, Real Estate Investment Trusts, 3 Tax Revision Compendium 1697, 1700 (1959).

2. Cary, Pressure Groups and the Increasing Erosion of the Revenue Laws, Joint Committee on the Economic Report, 84th Cong., 1st Sess. 260, 272 (1955).

3. Int. Rev. Code of 1954, §§ 851-55.

4. Int. Rev. Code of 1954, § 584.

5. Int. Rev. Code of 1954, §§ 701-71.

6. Int. Rev. Code of 1954, §§ 521-22.

7. Int. Rev. Code of 1954, §§ 801-18.

8. Int. Rev. Code of 1954, §§ 591-94.

9. Int. Rev. Code of 1954, §§ 821-23.

10. Int. Rev. Code of 1954, §§ 1371-77.

11. Int. Rev. Code of 1954, § 1361.

12. Int. Rev. Code of 1954, §§ 856-58.

13. Int. Rev. Code of 1954, § 857(b).

stances, as a matter of fiscal policy and equity, the conduit treatment of real estate investment trusts is not justified.

II. History of the Real Estate Investment Trust

A. *Judicial History*

Although earlier legislative income tax attempts were invalidated because they amounted to a direct tax on property not apportioned according to population,[14] the Tariff Act of 1909,[15] avoided this difficulty by imposing an excise tax measured by the corporate conduct of trade or business. Shortly thereafter, however, it was decided that realty trusts were exempt from this tax, as they were not "organized under the laws."[16] During this period, two Supreme Court cases noted the distinction between "passive" tax exempt trust holding and active conduct of business.[17] Vague though it must be, this distinction is inherent in the history and current status of realty trusts.

The Income Tax Act of 1913[18] deleted, in effect, both the requirement of organization under the laws and the condition of carrying on a trade or business. Nevertheless, investment companies holding securities or real estate were not deemed taxable under this act. The United States Supreme Court, in *Crocker v. Malley*,[19] held that trustees of a realty trust, which owned mills and collected rent, were not taxable at the trust level. Although the rationale of this case is the subject of dispute, its effect is certain. The Treasury in purporting to follow *Crocker*,[20] asserted a "beneficiary control" test as the determinative factor. If the trustees of a realty trust or investment company were free from effective control by the beneficiaries, the trust would be deemed a valid trust and would not be taxed as an "association."[21]

For the next few years this area was quiescent, the realty trusts and investment companies avoiding "association" taxation. In 1924, however, the Supreme Court, in *Hecht v. Malley*,[22] held that the basis for

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14. Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895).

15. Tariff Act of 1909, ch. 6, 36 Stat. 11.

16. Eliot v. Freeman, 220 U.S. 178 (1911).

17. Zonne v. Minneapolis Syndicate, 220 U.S. 187 (1911); Flint v. Stone Tracy Co., 220 U.S. 107 (1911).

18. Income Tax Act of 1913, ch. 16, § 2, 38 Stat. 114, 166.

19. 249 U.S. 223 (1919).

20. One commentator believes that the Treasury erred in its interpretation and that the decision was based on the ground that the trustees were exempt under the 1913 act from taxation because they were fiduciaries enjoying a 100% dividend credit. Contra, Kilpatrick, Real Estate Investment Trusts, 3 Tax Revision Compendium 1697, 1699 (1959).

21. For a list of the Treasury regulations and rulings during this period, see Woodrow Lee Trust, 17 B.T.A. 109-11 (1929).

22. 265 U.S. 144 (1924). Although this case involved a corporate excise tax on the

taxation as an association was the active conduct of trade or business and not beneficiary control. The test suggested was vague, namely, one of substantial resemblance to a corporation. Although *Crocker* was not expressly overruled, the basis of that decision was questioned. The Treasury then amended its regulations, purporting to follow the "active" test of *Hecht* rather than the "beneficiary control" test of *Crocker*.[23] As a result, confusion was induced in the lower courts and a number of conflicting decisions followed.[24]

The landmark decision of *Morrissey v. Commissioner*[25] was decided amidst this confusion. In four companion cases,[26] the trustees of Massachusetts trusts disputed the levy of an income tax on them as "associations,"[27] arguing they were strict trusts and not associations. In *Morrissey* the trustees were vested with powers to subdivide, develop, buy, sell, lease and encumber land and to operate a golf course and club houses—these powers being applicable to several properties. There was limited liability for the beneficiaries since the trust was organized as a continuing body with transferable shares and was a judicial entity for litigation purposes. The Supreme Court, in an opinion written by Mr. Chief Justice Hughes, held the trust taxable as an "association" because it constituted a joint effort for the doing of business and possessed the effectiveness and beneficial attributes normally obtained by adherence to an incorporation statute. The *Crocker* case was distinguished on the ground that there the trustees had only limited powers to collect income from specifically named properties.[28] Three concepts were offered for future edification with respect to the distinction between "ordinary trusts" and business trusts: (1) association or a "getting together" for joint enterprise; (2) business purposes; and (3) resemblance to the main corporate attributes.[29] Although much doubt was left by *Morrissey* as

privilege of doing business, the question with respect to "association" taxation was the same as involved in Crocker v. Malley, 249 U.S. 223 (1919).

23. For a list of the amended Treasury Regulations, see Morrissey v. Commissioner, 296 U.S. 344, 353-54 (1935).

24. See 84 U. Pa. L. Rev. 666-67 (1936). See also Rottschaefer, Massachusetts Trust Under Federal Tax Law, 25 Colum. L. Rev. 305 (1925).

25. 296 U.S. 344 (1935).

26. Swanson v. Commissioner, 296 U.S. 362 (1935) (powers to manage, control and sell an apartment building); Helvering v. Combs, 296 U.S. 365 (1935) (common enterprise for oil well operation); Helvering v. Coleman-Gilbert Associates, 296 U.S. 369 (1935) (management of apartment houses owned by the common venturers); Morrissey v. Commissioner, 296 U.S. 344 (1935) (powers of subdivision of land and operation of golf course).

27. The cases were under the Revenue Acts of 1924 and 1926. The definition of "association" in these acts was only: "The term 'corporation' includes associations, joint-stock companies, and insurance companies." Revenue Act of 1926, ch. 27, § 2(a)(2), 44 Stat. 9; Revenue Act of 1924, ch. 234, § 2(a)(2), 43 Stat. 253.

28. 296 U.S. at 350.

29. Id. at 356-60.

to what was to be considered an "association" taxable as a corporation, the inclusion of realty trusts and investment companies was apparent. A corporate tax was to be imposed on both security and realty trusts. The judiciary had concluded with the question, and the subsequent history was one of lobbying and legislation.

B. *Legislative History*

Inextricably tied with the history of real estate investment trusts is the regulated investment company statute,[30] as there is little dispute but that there would not have been any real estate investment trust legislation without the precedent of legislation for the regulated investment companies. It is unfortunate, therefore, that the congressional intent in enacting the regulated investment company statute is not clearly discernible. On the contrary, there is a conflict as to the historical motivation for this legislation.

"History" is often based on the personal view and interest of the historian. It is thus not surprising that a conflict of historical motivation is offered for the fact of regulated investment company legislation. On the basis of the "history" available, however, there is no conclusive support for either the proposition of a parity of position between security and realty trusts[31] or the proposition that the two are wholly distinguishable.[32]

Prior to the Public Utility Holding Company Act of 1935 and the *Morrissey* decision, investment companies had two bases on which to avoid corporate taxation: there was a 100 per cent intercorporate dividend deduction and there was the trust argument under the *Crocker* case.[33] Whether they existed in trust or corporate form, however, investment companies could minimize entity taxation since *Crocker* was available for the trusts and intercorporate dividends were fully deductible by corporations.[34] Then, in 1935, President Roosevelt proposed a reduction of the intercorporate dividend exclusion to ninety per cent. The distinction between security investment companies and real estate investment companies is supported by the following statement in the President's message proposing this change:

30. Int. Rev. Code of 1954, §§ 851-55.

31. Cf. Kilpatrick, Real Estate Investment Trusts, 3 Tax Revision Compendium 1697 (1959).

32. Cf. Cohen, Regulated Investment Companies, 3 Tax Revision Compendium 1653, 1654-57 (1959).

33. See note 19 supra and accompanying text.

34. There was a capital gains tax on the investment corporations, but this may not have been a factor in 1936 because "most of the investment companies had been formed in the late twenties when stock market prices were high and most capital gains were offset by capital losses which had developed during the depression years." Cohen, supra note 32, at 1655.

Bona fide investment trusts that submit to public regulation and perform the function of permitting small investors to obtain the benefit of diversification of risk, may well be exempted from this tax.[35]

The reduction in the intercorporate dividend deduction was enacted,[36] however, without any special provision for investment companies, and in the same year, 1935, the *Morrissey* case was decided. Thus, both grounds upon which the investment companies had been excluded from entity taxation were removed. Statutory relief was therefore sought.

Legislative history explaining the reasons for the regulated investment company legislation is sparse. A subcommittee of the Senate Finance Committee holding hearings preceding the Revenue Act of 1936 studied a provision for special treatment of regulated investment companies.[37] The full committee appears to have concluded that investment companies should be subjected to taxation as trusts and not as corporations.[38] Neither the special treatment provision nor the committee's conclusion seem to have been incorporated in the Revenue Act of 1936 as introduced.[39] However, a Senate floor amendment granting special tax treatment to certain open end investment companies was enacted without debate.[40] This special treatment was extended in 1940 to the excess profits tax[41] and to closed end companies in 1942.[42] The Investment Company Act of 1940 was enacted to provide for federal regulation of these companies.[43]

The realty trusts did not attempt to gain special treatment at the same time the security trusts did. This is important to note, as the most substantial argument the real estate investment trusts eventually brought to bear was, an alleged parity of position with regulated investment companies. It cannot be claimed that the realty trusts didn't know that special legislation was being considered because there were many interlocking directorships between trusts and investment companies.[44] Repre-

35. Address by President Franklin D. Roosevelt to Congress, H.R. Doc. No. 229, 74th Cong., 1st Sess. 4 (1935).

36. Revenue Act of 1935, ch. 829, § 102(h), 49 Stat. 1016.

37. Hearings Before the Senate Finance Committee on the 1936 Revenue Act, 74th Cong., 2d Sess. 776 (1936).

38. Id. at 803.

39. Revenue Act of 1936, ch. 690, 49 Stat. 1648, reduced the intercorporate dividend deduction from 90% to the present 85%.

40. Revenue Act of 1936, ch. 690, § 48(e), 49 Stat. 1669.

41. Second Revenue Act of 1940, ch. 757, § 201, 54 Stat. 975.

42. Revenue Act of 1942, ch. 619, § 361, 56 Stat. 878.

43. 54 Stat. 789, as amended, 15 U.S.C. § 80(a) (1958). The committee reports and commentators do not aid in ascertaining the original motivation for the special legislation. Cf. Weisenberger, Investment Companies (1957); Cohen, Regulated Investment Companies, 3 Tax Revision Compendium 1653 (1959).

44. See Kilpatrick, Real Estate Investment Trusts, 3 Tax Revision Compendium 1697

sentative Keogh, who sponsored the real estate investment trust legislation in Congress, stated:

I am informed that the practical reason . . . was that these trusts were generally operating at losses, due to defaults by tenants, and were not feeling the income tax pinch at the time.[45]

Whatever the reason—be it judgment that the position of the realty trusts differed from that of the investment companies, belief that success was unlikely, or lack of need due to the absence of taxable incomes—realty trusts did not seek and were not afforded special tax treatment when regulated investment companies were.

By the early 1950's many Boston realty trusts had been liquidated, and those that remained were "worth more dead than alive." Management firms with a great financial stake in keeping the trusts alive, law firms with a similar desire for continued existence, and owners hoping for increased return decided to attempt to obtain relief legislation. These groups sought, and were quite successful in obtaining, the support of other interests:

Among those interested in the passage of this legislation, in addition to the existing trusts, were private organizations such as the National Association of Real Estate Boards, the National Association of Home Builders, and the Mortgage Bankers Association. The legislation was also supported by such Government agencies as the Post Office Department, which hoped it would attract private capital into the construction of facilities to be leased to that Department, the Commerce Department, which saw its prospective use in the depressed industrial area program; and the Housing and Home Finance Agency. . . .[46]

With this alleged support, the lobbyists conferred with members of the House Ways and Means Committee and the Senate Finance Committee. Their early efforts received encouragement as the analogy to regulated investment companies seemed, at first glance, to be valid. Further, there were no opposing lobbying forces, with the exception of some muted opposition from the National Association of Investment Companies.[47]

In most congressional hearings on revenue legislation "there is practically no one, except perhaps the Treasury, available to represent the public."[48] In these hearings the Treasury was present, and it opposed

(1959). Most of the trusts had their main offices in Boston and, hence, are often referred to as the "Boston Trusts."

45. Letter From Representative Keogh to Mr. Theodore Lynn, March 2, 1961.

46. Letter From Representative Keogh to Mr. Theodore Lynn, April 6, 1961.

47. The reason for the muted opposition of the National Association of Investment Companies can only be presumed. Contemplated competition and fear of calling attention to many of their own practices may have been factors.

48. Cary, Pressure Groups and the Increasing Erosion of the Revenue Laws, Joint Committee on the Economic Report, 84th Cong., 1st Sess. 260, 273 (1955).

the legislation for six years.[49] Notwithstanding this opposition, however, a bill,[50] providing for relief to realty trusts did pass both houses of Congress in 1956, but was vetoed by President Eisenhower. The veto message contained two objections to the bill. The first was that there were substantial differences between realty trusts and realty investment companies:

> The income of regulated investment companies is generally derived from the securities of corporations which are fully subject to the corporate income tax. . . . [T]he conduit, treatment merely avoids an additional level of corporate taxation. . . . 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.[51]

The second ground for the veto was the fear that the real estate investment trust bill would extend beyond the realty trusts to other 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.[52]

Several later efforts by those favoring such legislation were even less successful. In 1957, a bill[53] identical to that vetoed by President Eisenhower[54] was passed by the House, but the Senate never acted upon it. In 1958, the Senate passed a slightly different version and added to it the Technical Amendments Act of 1958[55] but this addition was later deleted by the Conference Committee. Shortly thereafter, the Treasury changed its position and the real estate investment trust bill[56] was introduced in the House by Representative Keogh of New York. It passed the House by a voice vote on June 29, 1960, was agreed to in Conference, and was signed into law by President Eisenhower on September 14, 1960.[57]

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49. An early Treasury reaction is alleged to be: if realty trusts can take a deduction for distributed income why can an automobile company not do so? The automobile company can be said to be only in the business of investing in automobiles and passing on the income to shareholders.

50. H.R. 4392, 84th Cong., 2d Sess. (1956).

51. 102 Cong. Rec. 15304, 15305 (1956).

52. Ibid.

53. H.R. 8102, 85th Cong., 1st Sess. (1957).

54. See note 50 supra.

55. H.R. 8381, 85th Cong., 2d Sess. (1958).

56. H.R. 12559, 86th Cong., 2d Sess. (1960).

57. Pub. L. No. 86-779, 86th Cong., 2d Sess. (Sept. 14, 1960).

III. Analysis of the Code Provisions and Treasury Regulations

As a result of this legislation, a new entity, the real estate investment trust, was made available for service as a tax free conduit for distributed net income. The new law took effect on December 31, 1960[58] and on April 28, 1962, the final treasury regulations pertaining to it were promulgated.[59]

A. *Organization Attributes for Real Estate Investment Trust Qualification*

To qualify as a real estate investment trust, an entity must: (1) be organized as an unincorporated trust or association;[60] (2) be managed by trustee(s);[61] (3) contain transferable shares or certificates held by 100 or more persons;[62] (4) be taxable as a domestic corporation but for this law;[63] (5) elect irrevocably to be treated as a real estate investment trust;[64] (6) avoid control by five or fewer individuals of fifty per cent or more of the trust's beneficial ownership during the last half of the taxable year;[65] (7) avoid the holding of any property for sale to customers in the ordinary course of trade or business;[66] and (8) meet the requirements of the law respecting assets, diversification, income, and distribution.[67]

1. Unincorporated Trust or Association

It is clear that a corporation cannot qualify as a real estate investment trust because of this provision,[68] but there still seems to be some question as to the ability of limited partnerships to qualify. Although the statute requires management by "trustees," it permits "unincorporated associations" to qualify. Confusion was induced by this, since the latter are not usually managed by trustees. The proposed regulations expressly stated that an entity considered under state law to be a limited partnership could not qualify "because a partner thereof is not considered to be a trustee. . . ."[69] This statement, however, has been deleted

58. Int. Rev. Code of 1954, §§ 856-58.

59. Treas. Regs. §§ 1.856-1 to 1.858-1 (1962).

60. Int. Rev. Code of 1954, § 856(a).

61. Int. Rev. Code of 1954, § 856(a)(1).

62. Int. Rev. Code of 1954, §§ 856(a)(2), 856(a)(5).

63. Int. Rev. Code of 1954, § 856(a)(3).

64. Int. Rev. Code of 1954, § 856(c)(1).

65. Int. Rev. Code of 1954, § 856(a)(6).

66. Int. Rev. Code of 1954, § 856(a)(4).

67. Int. Rev. Code of 1954, § 856(c)(2)-(6).

68. H.R. 1806, 87th Cong., 1st Sess. (1961) would have extended qualification to corporations, but it was not enacted.

69. Proposed Treas. Reg. § 1.856-1(d)(1), 26 Fed. Reg. 604 (1961).

from the final regulations and, therefore, it might be argued that the inconsistency has been resolved in favor of allowing qualification for limited partnerships. But the Code also prescribes that a real estate investment trust must be subject to the corporate income tax but for qualification. Limited partnerships are usually not subject to the corporate tax so that doubt still remains as to whether a limited partnership may qualify as a real estate investment trust.

2. Management by Trustee(s)

The proposed regulations defined a "trustee" as one who holds legal title to the property, has exclusive control over the trust management and affairs "free from any power of control on the part of shareholders other than the right to elect trustees," and has exclusive control over property management including the sale thereof.[70] This definition elicited much protest among the interested parties. One commentator argued that shareholders should be permitted to amend and terminate the trust, vote on mortgaging or selling substantially all the trust property, approve trustee compensation, remove trustees, and approve management contracts.[71] A second noted that state law restrictions require the use of nominees in certain situations and, therefore, suggested that this should be allowed.[72] The final treasury regulations have incorporated some of the above suggestions. Now, the trustee's continuing exclusive authority over the management and affairs of the trust will be considered to exist "even though the trust instrument grants to the shareholders" the rights and powers "to elect or remove trustees; to terminate the trust; and to ratify amendments to the trust instrument proposed by the trustee."[73] Furthermore, the trustee will be considered as holding legal title to the trust property even when the title is held in the name of a nominee for the exclusive benefit of the trust.[74]

Certain critics' suggested changes, such as beneficiary power to amend the trust, hire the independent contractor and approve trustee compensation, were not included. It is submitted that this was correct since Congress specifically chose the business trust form which is traditionally one of little control by the beneficiary. This entire question recalls the recurring theme that conduit treatment has been granted in an area where the end limits are ones of degree rather than of kind. While there is no logical reason to stop at the traditional business trust concept, this

70. Ibid.

71. Robbins, Comments Upon Proposed Regulations Relating to Real Estate Investment Trust, and Their Shareholders—Subchapter M (1961).

72. Letter From Mr. Joseph W. Lund to the Internal Revenue Service (1961).

73. Treas. Reg. § 1.856-1(d)(1) (1962).

74. Ibid.

is where Congress arbitrarily drew the line, and it is no less logical than any other line.

On the question of choice of trustees, it has been suggested that some of the principal investors who have real estate experience should be chosen. The prohibition against serving as both trustee and independent contractor must, however, always be observed.[75] Finally, state rules against perpetuities may be applied against the trust and thus it might be wise to include as "lives in being," young children of the trustees in order to obtain additional continuity.

3. Transferability and the 100 Shareholder Requirement

The free transferability of the "certificates of beneficial interest"[76] is one of the major intended advantages of the real estate investment trust form. The small investor is supposed to be benefited when he can freely transfer his shares. The proposed regulations were silent on the extent, if any, to which trading may be limited. The final regulations on the other hand, render effective provisions in the trust instrument which permit the trustee to bar transfer or redemption of shares when he "in good faith" believes transfer would result in the loss of the status as a real estate investment trust.[77] This restriction appears quite drastic when the legislative intent is considered. To what extent this provision may be used by the trustee remains to be seen.

A real estate investment trust must have a minimum of 100 shareholders. This requirement is intended to assure a broad base of ownership. One commentator notes that it would be unwise to begin a real estate investment trust unless there were substantially more than 100 shareholders because of future uncertainty about transfers.[78] Consistent with the intention, there is no attribution of ownership in determining the 100 shareholders figure.[79] Informational returns from both the trust and shareholder are required for determination of this figure. Some, who protest that many of the reporting requirements are too burdensome, suggest that an exemption should be granted those shareholders who own less than five per cent of the real estate investment trust. This would be similar to regulated investment company procedure. The five per cent exemption has not been adopted in the final regulations although there has been some revision of the reporting requirements.

75. See note 115 infra and accompanying text.

76. Int. Rev. Code of 1954, § 856(a)(2).

77. Treas. Reg. § 1.856-1(d)(2) (1962).

78. Roberts, Feder & Alpert, Congress Approves Real Estate Investment Trusts; Exacting Rules Made, 13 J. Taxation 194, 198 n.71 (1960). This was written before the allowance of "good faith" transfer restrictions.

79. Treas. Reg. § 1.856-1(d)(2) (1962).

4. Unincorporated Organization Taxable as a Corporation

The trust must be taxable as a domestic corporation but for the real estate investment trust law. The regulations incorporate sections 7701(a)(3)-(4) and treasury regulations 301.7701-2 for a determination of corporate taxability and the "objective to carry on business."[80] This provision is also important in the determination of which attribution rules—trust or corporation—apply to real estate investment trusts. It is submitted that the corporate rules[81] and not the trust rules[82] apply to real estate investment trusts. First, there is this section which requires that a real estate investment trust be taxable as a domestic corporation, and not a trust, but for this law. Second, section 7701(a)(3) defines corporation to include entities similar to real estate investment trusts. Third, section 856(d) specifically alters the corporate attribution section[83] and to be meaningful, this addition would seem to require use of that section.

Since the entity would be taxed as a corporation but for its qualification as a real estate investment trust, the regulations note that sections which affect corporations apply to the extent they are not inconsistent with this law.[84]

5. Irrevocable Election

The election by an entity to be taxed as a real estate investment trust is not only irrevocable, but the election probably cannot be revoked even with Internal Revenue Service approval.[85] Failure to qualify, therefore, only affects the tainted year and the original election is in force for any subsequent years.

An election may be made by the trust in any year it desires, even though it may have otherwise qualified for a prior year. This election option was added by the final regulations.[86] While it might have been unfair to deny real estate investment trust status due to inadvertent failure to elect in an earlier year, this election option seems to provide a tax "windfall." Individuals can now form limited partnerships for the early years when there are "losses" due to depreciation deductions in excess of cash flow. These "losses" can be taken as deductions on the partners' individual tax returns. Real estate investment trust status

80. Treas. Reg. § 1.856-1(d)(3) (1962).

81. Int. Rev. Code of 1954, § 318(a)(2)(C).

82. Int. Rev. Code of 1954, § 318(a)(2)(B).

83. Int. Rev. Code of 1954, § 318(a)(2)(C).

84. Treas. Reg. § 1.856-1(e) (1962).

85. See Treas. Reg. § 1.856-2(b) (1962); see Roberts, Feder & Alpert, Congress Approves Real Estate Investment Trusts; Exacting Rules Made, 13 J. Taxation 194, 197 (1960).

86. Treas. Reg. § 1.856-2(b) (1962).

can later be elected when the depreciation deductions are not sufficient to offset taxable income.

6. Personal Holding Company Status

If more than fifty per cent of the trust is owned by not more than five individuals during the last half of the taxable year, the entity cannot qualify as a real estate investment trust. The test is made by considering all the trust's income and asking whether the resulting entity is a personal holding company.[87] Certain charitable foundations and trusts are considered individuals for the purposes of this determination.

7. Sale of Property in the Ordinary Course of Business

The holding of property for sale to customers in the ordinary course of business will disqualify a real estate investment trust. Whether the trust holds any property primarily for sale to customers in the ordinary course of business is a determination of fact for which standards cannot be set in advance.[88] The test is whether an entity is engaging in the "trade or business" of buying and selling property and it is submitted that the most important consideration will be the frequency of sales. The purpose of this requirement is to compel the real estate investment trust to remain a passive investment instrument rather than an active real estate operation.[89]

B. *Income Tests for Qualification as a Real Estate Investment Trust*

Three interacting gross income provisions must be satisfied by an entity which wishes to qualify as a real estate investment trust. First, ninety per cent of the trust's gross income must be derived from certain types of investments.[90] Second, seventy-five per cent of the entity's gross income must be derived from interests in real property.[91] Third, not more than thirty per cent of the trust's gross income may be derived from short term dispositions.[92] The crucial concept of "rents from real property" is analyzed thereafter.

1. The Ninety Per Cent Income Test

Ninety per cent of the trust's gross income must be derived from dividends, interest, "rents from real property," gain from the disposition of stock, securities, interests in mortgages, and real property, and abate-

87. Treas. Reg. § 1.856-1(d)(5) (1962).
88. Treas. Reg. § 1.856-1(d)(4) (1962).
89. H.R. Rep. No. 2020, 86th Cong., 2d Sess. 6 (1960).
90. Int. Rev. Code of 1954, § 856(c)(2).
91. Int. Rev. Code of 1954, § 856(c)(3).
92. Int. Rev. Code of 1954, § 856(c)(4).

ments or refunds of taxes on real property. This test is similar to a ninety per cent prescription for regulated investment companies, with the addition of income from real property interests.

2. The Seventy-Five Per Cent Income Test

Seventy-five per cent of the trust's gross income must be derived from such interests in real property as rents, mortgages, sales, tax rebates, and other qualified real estate investment trusts. This injunction has no parallel in the regulated investment company statute and is motivated by the legislative desire that most trust income be elicited from investment in real property interests.[93] The terms "rents from real property" and "real property" are terms of art and are separately defined.[94] "Interests in real property" includes fee ownership or leasehold interests in land or fixtures, but does not include mineral, oil or gas royalty interests.[95]

Although distributions from other qualified real estate investment trusts are permitted in the seventy-five per cent income test, it will usually be unwise for one trust to hold shares in another. The first trust would have no control over the second and could not assure that the second trust would qualify for real estate investment trust tax treatment. If the second trust failed to qualify, distributions from it would not be includible for the seventy-five per cent income test of the first. Therefore, a disqualification of the second trust could result in a disqualification of the first. Note also, there could be a disastrous "snowballing" effect if there were substantial interlocking holdings: the disqualification of A leading to the disqualification of B, the disqualification of B leading to the disqualification of C, and so forth.[96]

An apportionment is required when income is derived in part from real estate and in part from another source, since only real estate interest income is comprehended by the seventy-five per cent income test.[97] This is consistent with the purpose of the seventy-five per cent income test, which is to restrict the major portion of the trust's income to traditional real estate interests. Thus, if some rent is received for the lease of real estate and personalty, only the payment for the real estate is included in the seventy-five per cent income test.

The combined effect of the interaction of the ninety per cent income test and the seventy-five per cent income test is that seventy-five per cent of the trust's gross income must be derived from real property sources, fifteen per cent must come from either real property interests or any

93. H.R. Rep. No. 2020, 86th Cong., 2d Sess. 5 (1960).

94. See notes 100 & 102 infra and accompanying text.

95. Treas. Reg. § 1.856-3(c) (1962).

96. See Treas. Reg. § 1.856-3(b) (1962) for special rules.

97. See, e.g., Treas. Reg. § 1.856-2(c)(2)(ii) (1962); Treas. Reg. § 1.856-4(a) (1962).

source from which a regulated investment company could derive qualified income, and ten per cent may be gathered from any source whatever.

3. The Thirty Per Cent Income Test

There is one prohibition which is grafted upon the above tests. Not more than thirty per cent of a trust's gross income may come from the short-term sale of stock within six months of purchase or from the sale of realty held for less than four years.[98] Losses are not netted with gains for this test. The purpose of this rule is to discourage speculation by the real estate investment trust. It is another of the prescriptions which attempt to keep the trust "passive." Perhaps the four year holding period is harsh and the three year rule applicable to collapsible corporations is more appropriate.[99]

4. Rents From Real Property

The only rents comprehended in the seventy-five per cent income test are "rents from real property." This is a term of art which will provide many difficult problems. The concept has been used to assure that the real estate investment trust remain a "passive" investment vehicle rather than an "active" real estate operation. Therefore, the statute blocks out exceptions from the inclusive definition that the term "rents from real property" includes rents from interests in real property, but does not include[100] (a) rent derived from nonreal property, (b) rent whose computation depends on the income or profit of the tenant, (c) rent received due to ownership of the tenant, and (d) rent derived from the rendering of services or management by the real estate investment trust. The corporate attribution rules are to apply to these exclusions from the seventy-five per cent income test, but ten per cent ownership is substituted for fifty per cent ownership.[101] The complexities induced by "rents from real property" are inherent since "passive" and "active" in the real estate investment trust context differ in degree rather than in kind.

(a) Rent Derived From Nonreal Property

Rent which is not gathered from real property cannot be used for purposes of the seventy-five per cent income test. "Real property" is not defined in the Code, but the final regulations contain the following:

> The term "real property" means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including . . . structural com-

98. Int. Rev. Code of 1954, § 856(c)(4).

99. See Williamson, Realty Investment Trusts Poised for Launching, 192 The Commercial and Financial Chronicle, No. 5992 (Oct. 6, 1960).

100. Int. Rev. Code of 1954, § 856(d).

101. Ibid.

ponents . . .). In addition, the term . . . includes interests in real property. Local law definitions will not be controlling. . . .[102]

"Interests in real property" include:

[F]ee ownership and co-ownership of land or improvements thereon, and leaseholds of land or improvements thereon. Such term does not . . . include mineral, oil, or gas royalty interests. . . .[103]

These rather vague definitions are buttressed by a list of specific items. The final regulations state that the following are to be considered "real property":

the wiring in a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure.[104]

The following are to be excluded from the term "real property":

assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.[105]

The potential disputes regarding specific items may become legion. For example, the proposed regulations were silent on the subject of elevators. One commentator feared that elevators might be considered "transportation equipment," which is not "real property." Hence, the final regulations added elevators to the list of included items. Further questions may require extensive litigation. A federal law of fixtures also seems to be required, since state law is not determinative and would only promote forum shopping.

(b) Rent Computed According to the Tenant's Income or Profits

Since the "passive-active" distinction requires that a trust not participate in the active business of a tenant, there is excluded from the seventy-five per cent income test those rents which are based on the income or profits of the tenant. This is intended to prevent profit sharing between trust and tenant.[106] The penalty for breach of this injunction is drastic since the entire rent from the tenant is disqualified, even though a large portion may be determined without regard to the tenant's income or profits.

An advance agreement to compute rent on a fixed percentage or the

102. Treas. Reg. § 1.856-3(d) (1962).
103. Treas. Reg. § 1.856-3(c) (1962).
104. Treas. Reg. § 1.856-3(d) (1962).
105. Ibid.
106. See H.R. Rep. 2020, 86th Cong., 2d Sess. 7 (1960).

tenant's gross receipts or sales is, however, permissible. The theory is that these fixed percentage leases are usually not considered as being related to the active business of the tenant. There is ambiguity regarding the extent to which gross receipts or sales may be adjusted before a percentage lease is deemed a participation in profits. The final regulations allow an adjustment for merchandise returns and sales taxes.[107] By an exclusion argument, it may be that no other adjustments are permissible. But the committee report seemed to envisage a broader scope when it spoke of allowing adjustments for "such items as returned merchandise, or Federal, State, or Local sales taxes."[108] "Such items as" seems to encompass more than the stated examples. Hence the question of to what extent the gross receipts may be adjusted in a fixed percentage lease remains an open one.

If the real estate investment trust has a fixed gross receipts tenant, such tenant cannot sublease for a percentage of profits. If there is such a sublease, the entire rent from the prime tenant is excluded from the seventy-five per cent income test. The theory is that the rent received by the trust is based on the gross receipts of the tenant, and such gross receipts are based on the profits of an active business. Hence the trust's rent is indirectly based on the profits of an active business. It is submitted that this provision of the regulations is faulty statutory construction. The seventy-five per cent income test refers only to "its tenant," and this seems to mean the prime tenant only. The real estate investment trust is getting rent from the gross receipts of its tenant, and the method by which the tenant gains its gross receipts should not be a factor. If the Internal Revenue Service fears "sham" arrangements, there is ample precedent for disqualification on the "sham" ground alone. Note also that the entire rent from the prime tenant is disqualified even if only a minor sublease is based on a profit rental. Furthermore, this rule is impractical in that it requires the trust to actively supervise the subleasing of its tenants. Real estate investment trusts may have to require that every tenant submit for approval every sublease. Not only will tenants balk at such a restriction, but such active supervision by the trust itself is inconsistent with the "passive" or conduit theory.

"Overage" provisions which provide for additional rent if profits exceed a stipulated amount are not allowed. But, unlike the proposed regulations,[109] the final regulations allow the fixed rent to be included in the seventy-five per cent income test unless some rent under the "overage" provision is actually received.[110] There is a "literal" method

107. Treas. Reg. § 1.856-4(b)(1) (1962).

108. H.R. Rep. No. 2020, 86th Cong., 2d Sess. 10 (1960).

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

110. Treas. Reg. § 1.856-4(b)(1) (1962). The entire rent is disqualified even if an "overage" amount received is very minor.

of including an acceptable "overage" provision. Additional rent based on a percentage of gross sales or receipts is not based on net profit and, therefore, avoids the literal injunction. There is, however, the danger of a "substance-form" judicial decision, and benefits derived from such a provision will not usually be commensurate with the risks involved.

The final regulations also included the following statement which was absent from the proposed regulations:

> [A]n amount will not qualify as "rents from real property" if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practices but is in reality used as a means of basing the rent on income or profits.[111]

It will create great difficulty if the regulations contemplate the Internal Revenue Service determining "business practices" in real estate leases, as such trade practice is a varied and confused area. It is hoped that this provision only means that substance and not form controls.

(c) Rent Received Due to Ownership of the Tenant

Rent from any person in whom the trust owns ten per cent interest is disqualified from the seventy-five per cent income test in order to prevent a substantial relationship between the trust and the business of any tenant.[112] Yet, a substantial relationship seems possible through the medium of individuals who own less than ten per cent of either the trust or the corporate tenant. There will be no attribution of ownership unless ten per cent of the shares are owned by a single person since the corporate attribution rules seem to apply.[113] If the prime tenant subleases property and the trust owns more than ten per cent of the sublessee, only the portion of the prime tenant's rent derived from the sublessee is disqualified from the seventy-five per cent income test.[114]

(d) Rent Derived From the Trust Rendering Services or Management

Rent from a trust rendering services or management is disqualified from the seventy-five per cent income test.[115] Again, the purpose is to compel the trust to remain a passive investment instrument. Active management functions and services must be provided by an "independent contractor." The theory is that tax free conduit treatment should only

111. Treas. Reg. § 1.856-4(b)(1) (1962).

112. Treas. Reg. § 1.856-4(b)(2) (1962). If the person is a corporation, the trust cannot own either ten per cent of the total voting power or ten per cent of the total number of outstanding shares of all classes. If the person is not a corporation, the trust cannot own ten per cent of its assets or net profits.

113. See note 81 supra and accompanying text.

114. Treas. Reg. § 1.856-4(b)(2) (1962).

115. Int. Rev. Code of 1954, § 856(d)(3); Treas. Reg. § 1.856-4(b)(3) (1962).

be given to receipts earned from passive investment in realty. The income from active services should be received by another taxpayer who is taxed according to the regular taxation rules.

There are numerous technical rules defining "independent contractor" and governing the relationship between the contractor and the trust. The contractor may not own more than thirty-five per cent of the trust and common ownership of the trust and contractor in excess of thirty-five per cent is prohibited.[116] The trust may not receive any income from the contractor and the contractor must be adequately compensated for its services. The trustee may not have any interest in the contractor and the contractor may not be an employee of the trust.[117] "The requirement that the trust not receive any income from an independent contractor requires that the relationship between the two be an arm's-length relationship."[118]

Yet the conference report may have been optimistic when it stated: "The independence of the contractor is assured by providing"[119] the technical rules. Assume a situation where a trust and its corporate tenant are owned by the same people, but no single individual owns ten per cent of either. Assume further that thirty-four per cent of the stock of the independent contractor is owned by persons owning thirty-four per cent of the trust and thirty-four per cent of its corporate tenant, while all of the other technical requirements are satisfied. In such a situation, there will often be substantial common control of the trust and contractor in practice, if not in form. Assume a second situation where an individual forms a real estate investment trust and becomes a trustee of it. He then severs all connection with a managing firm he used to control, although said "independent contractor" continues to bear his name. His wife and children continue as stockholders in the independent contractor. Not only does the "arm's-length relationship" seem subverted, but the prohibition against trustee participation in the contractor seems abused. Yet this was the procedure used in one of the earliest real estate investment trusts. Whether it will be upheld remains to be seen.

More time was devoted to the concept of "independent contractor" at the hearings for the regulations than to all the other problems combined. Many attacked specific problems and others opposed the concept of having strangers manage the properties. Possibilities of conflict of interest were cited and some feared that the independent contractors might make costly decisions which the trustees could not control. Perhaps

116. Ibid.
117. Ibid.
118. Treas. Reg. § 1.856-4(b)(3)(i)(d) (1962).
119. H.R. Rep. No. 2020, 86th Cong., 2d Sess. 7 (1960).

because of the hue and cry, the final regulations have extensively revised the proposed regulations on the issue of "independent contractor." The regulations first distinguish between those "services" which an independent contractor must perform and the fiduciary duty to manage the trust itself, which the trustees may retain:

[T]he trustees may establish rental terms, choose tenants, enter into and renew leases, and deal with taxes, interest, and insurance, relating to the trust's property. The trustees may also make capital expenditures . . . (as defined in section 263) and may make decisions as to repairs . . . (of the type . . . deductible under section 162), the cost of which may be borne by the trust.[120]

Then the regulations divide the concept of "services" into two categories: "customary services for which no separate charge is made" and "services for which a separate charge is made." Rent received for the former will not be disqualified from the seventy-five per cent income test as long as an independent contractor performs them, while rent received for the latter will be disqualified. That which is customary and that which is not customary is to be determined separately in each factual situation.

It is rather unpleasant to realize that the question of trust qualification, with its important economic consequences, may depend on whether a telephone answering service is customary or extraordinary in the specific fact pattern. It is not of much help to be told:

The supplying of water, heat, and light; the cleaning of windows, public entrances, exits, and lobbies; the collection of trash; and the furnishing of elevator service, telephone answering service, unattended parking lots, and watchman or guard services are examples of services which *may or may not* (depending upon the circumstances) be customary or incidental to the mere rental of multiple-occupancy real estate.[121]

The only examples of services which are not customary are:

The furnishing of hotel, maid, boarding house, motel, attended parking lot, warehouse, or storage services. . . .[122]

The independent contractor must perform even customary services, whatever they are, but the trust can bear the cost for them. The cost of services which are not customary must be borne by the contractor and a separate charge must be made for them. The independent contractor must retain any amounts separately paid by the tenants for "services," be they customary or noncustomary. A method of compensating the contractor must be devised which will prevent the trust from receiving income from services and which assures that the con-

120. Treas. Reg. § 1.856-4(b)(3)(i)(d) (1962).

121. Treas. Reg. § 1.856-4(b)(3)(i)(b) (1962). (Emphasis added.)

122. Treas. Reg. § 1.856-4(b)(3)(i)(c) (1962).

tractor will include in his taxable income all active service income. Whether the trust can act as agent for the contractor in receiving money from the tenants and passing it on to the contractor is unresolved. Reasonable compensation based on an unadjusted percentage of gross rents will usually be allowed.

The regulations are the only tangible "guide-lines" available regarding the independent contractor device. The purpose of the concept is to assure that the real estate investment trust will not derive any income from active services, which income should be taxed to the independent contractor outside the realty trust rules. But the several vague conceptual distinctions and the profusion of factual variations may result in inadvertent disqualification and extensive litigation. It remains to be seen whether the solution will not create more difficulties than the original problem contemplated. The independent contractor concept, so vague in theory, may become chaos in practice.

C. *Asset Tests for Qualification as a Real Estate Investment Trust*

These rules deal with the nature of the assets and are to be distinguished from the previously discussed rules regarding source of income. The statute provides for three tests regarding the type of assets which a real estate investment trust may hold. First, seventy-five per cent of the value of the trust's total assets must be in real estate, cash items, and government securities.[123] Second, *not more than* twenty-five per cent of the value of the trust's total assets may consist of nonqualifying assets.[124] Third, not more than five per cent of the assets may be of the nonreal-estate securities of any single issuer, nor may the trust hold more than ten per cent of the voting securities of any single nonreal-estate issuer.[125]

1. The Seventy-Five Per Cent Asset Test

Real-estate assets, cash items and government securities must comprise seventy-five per cent of a trust's total assets. The definition questions regarding "real property" and "interests in real property" have been discussed previously.[126] The purpose of the seventy-five per cent asset test is to require that the bulk of trust investments be placed in real estate.

The seventy-five per cent asset test is one of comparative values at a given time and the adjusted bases of the assets are irrelevant. "Value" is defined as the fair market value as determined in good faith by the

123. Int. Rev. Code of 1954, § 856(c)(5)(A).

124. Int. Rev. Code of 1954, § 856(c)(5)(B).

125. Ibid.

126. See notes 100-02 supra and accompanying text.

trustees, except that the value of securities traded on an exchange are their market quotations.[127] "Total assets" means gross assets and it is doubtful that a deduction for mortgages or rental obligations will be allowed.

The determination of whether the value of the trust's qualifying assets constitutes seventy-five per cent of its total assets need only be made at the end of those quarterly periods in which the trust has acquired new property. Therefore, nonreal-estate asset "paper" appreciations in years without acquisitions will not result in disqualification. Furthermore, the trust has thirty days to eliminate any discrepancies resulting from a comparative computation.

It may be that requiring valuation in the event of a minor acquisition will be costly and burdensome. The disposition of substantially appreciated property might be required if the seventy-five per cent asset test is not satisfied, and the trust might incur a high tax cost. But it is submitted that the law strikes a fair balance between a cumbersome procedure of quarterly valuation and the desire that the bulk of the trust's investments be placed in real estate.

Valuation would be required far more often if the trust wished to be "open ended." An "open end" company guarantees to sell or redeem its own shares at a price derived from an allocation of the underlying assets. A "closed end" company exhibits a fixed capital structure and does not sell or redeem its shares after the initial offering. It is submitted that an "open end" trust will serve the small investor philosophy of the real estate investment trust law better than a "closed end" trust. The small investor prefers the liquidity of an "open end" trust. He prefers a valuation of his interest which depends on underlying assets rather than the vagaries of the stock market. Yet, most of the known "open end" funds are valued daily. This is feasible when the fund's assets are comprised of securities which have daily market valuations, but it is quite difficult when relatively fixed real estate assets are involved. The second problem with an "open end" real estate investment trust is the lack of liquidity of real estate assets as compared with the liquid securities which comprise the bulk of regulated investment company assets. It is submitted that the valuation difficulty might be met by monthly valuation. Redemption would be on a monthly basis, with those who present their stock in the first twenty days of the month receiving redemption at the end of the month. The trust would then have some time to sell sufficient assets to meet a normal amount of redemptions. Liquidity might be achieved by a "standby" purchase agreement bank loan, or by a surety bond.

127. Treas. Reg. § 1.856-3(a) (1962).

An unintended use of the real estate investment trust device may be trusts which deal solely in mortgages. Since mortgages on real estate are comprehended in the seventy-five per cent asset test, a trust could hold mortgages exclusively and still be granted a tax free "pass-through" of income. High return but risky second mortgages could also be held. This type of trust would also save expenses, as an independent contractor would be unnecessary.

2. The Twenty-five, Five and Ten Per Cent Asset Tests

The Code states:

> [N]ot more than 25 percent of the value of the [trust's] total assets is represented by securities [other than those comprehended in the 75 per cent assets test] for purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the trust and to not more than 10 percent of the outstanding voting securities of such issuer.[128]

The presumed purpose of these tests is to provide diversification for the trust's nonreal-estate investments. But if the trust meets the seventy-five per cent asset test, it cannot possibly violate the twenty-five per cent requirement: "not more than" twenty-five per cent of the trust's total assets could possibly be in nonqualifying securities if seventy-five per cent were in qualifying assets. Since the five per cent and ten per cent limitations are to be used "for the purposes of this calculation," they too could not possibly disqualify the trust if it meets the seventy-five per cent asset test. Hence there is an apparent error in draftsmanship. The congressional intention for diversification is clear and the final regulations ignore the statute and follow that intention. They, therefore, state that no more than five per cent of the total assets of a trust may be in the nonreal-estate securities of any single issuer. They also assert that the trust may not hold more than ten per cent of the voting securities of a nonreal-estate issuer. It remains to be seen whether these regulations will be sustained.[129]

No provision whatever is made for diversification of a real estate investment trust's real property interests. The above discussion relates only to the possible diversification of nonreal property interests. A trust which holds but one office building is, therefore, a distinct possibility. A number of such trusts have already been formed. This fact should

128. Int. Rev. Code of 1954, § 856(c)(5)(B).

129. Mr. Wilfred Godfrey, Comptroller of the Keystone Funds, has stated in an unpublished letter to the Internal Revenue Service that the root of the drafting difficulty was probably an attempt to incorporate a regulated investment company provision within the real estate investment trust law. Mr. Godfrey prefers the "literal" interpretation and would, therefore, delete Treas. Reg. § 1.856-2(d)(4) examples (2) and (3) as not supported by law.

be contrasted with the often mentioned statement that real estate investment trusts will provide diversification of real estate investment for small investors.

D. *Taxation of a Real Estate Investment Trust and Its Beneficiaries*

The Code provides three rules for the taxation of a real estate investment trust and its beneficiaries. First, the trust may take a deduction from the corporate tax for all distributed ordinary income[130] and capital gains.[131] Second, it must distribute ninety per cent of its "real estate investment trust taxable income."[132] Third, the beneficiary is taxed on trust income as if it were income received directly from the underlying real-estate assets.[133]

1. Deduction for Distributed Income

The real estate investment trust is granted a deduction from the corporate income tax for all dividends paid to beneficiaries which are derived from ordinary income. There is also a deduction from corporate capital gain for dividends paid from capital gains, but this "pass-through" is limited to the year of sale. The trust is taxed as a regular corporation on all accumulated income and capital gains. The real estate investment may not take an intercorporate dividend deduction[134] in that the factor of double taxation is absent. The trust may not "pass-through" a foreign tax credit to its shareholders since Congress did not intend to have trusts specialize in foreign investments.[135]

2. The Ninety Per Cent Distribution Requirement

The trust is required to take a deduction for the distribution of ninety per cent of its noncapital gains income. The effect of this prescription is to impose on the trust the obligation of distributing ninety per cent of its ordinary income. The purpose of the provision is to compel the trust to act as the conduit for which it was intended.

The ninety per cent distribution requirement will not be effective in certain situations. It compels conduit treatment only when taxable

130. Int. Rev. Code of 1954, § 857(b)(2)(C).

131. Int. Rev. Code of 1954, § 857(b)(3)(A)(ii).

132. Int. Rev. Code of 1954, § 857(a)(1). The distribution rules are imposed on the basis of the taxable year, but some mitigation of the requirements is available. If a real estate investment trust declares a dividend before March 15th of the year following the taxable year, and said dividend is distributed by December 31st of the following year, then it is deemed as having been paid during the first year. See Int. Rev. Code of 1954, § 858(a). This allows the use of income for as long as twelve additional months.

133. Int. Rev. Code of 1954, §§ 61, 857(b)(3)(B).

134. Int. Rev. Code of 1954, § 857(b)(2)(B).

135. See H.R. Rep. No. 2020, 86th Cong., 2d Sess. 8 (1960).

income is a large component of net cash flow (income before deduction for depreciation). The allowable deduction for depreciation is often much larger than the actual deterioration of the physical assets. It will be possible for a real estate investment trust to retain much of its actual income when the depreciation deduction reduces taxable income to a small percentage of the cash flow. For example, a public real-estate corporation had a six million dollar cash flow in 1960 but no taxable income due to a depreciation deduction of seven million dollars.[136]

Failure to comply with the ninety per cent distribution requirement results in disqualification of the real estate investment trust. Therefore, trustees must be very careful not to claim more depreciation than they are entitled to under the law. Excessive depreciation will lead to an erroneous computation for taxable income. This might result in the trust distributing less than ninety per cent of the true taxable income. Furthermore, the additional corporate tax due might not be discovered for a number of years and the result would be quite disastrous for a real estate investment trust which did not accumulate large reserves.

There is one conceivable situation where the ninety per cent distribution requirement will be too effective. Cash flow will be less than the taxable income when amortization payments on a debt exceed the depreciation deduction. This might require the distribution of an amount in excess of the trust's ordinary income.

3. Taxation of the Shareholder

A "dividend" from the real estate investment trust is ordinary income to the beneficiary. The one exception is a dividend derived from capital gains, in which event it is capital gains income to him. The real estate investment trust must designate which dividends are from capital gains, and a pro rata reduction must be effected in the event of designations in excess of the actual real estate investment trust capital gains for the year.[137] Any corporation which receives a dividend from a trust cannot consider it a "corporate dividend" for purposes of the eighty-five per cent intercorporate deduction. Also the four per cent dividends received credit and the $50 dividends received exclusion are not available since there is no double corporate taxation in the real estate investment trust context. The "dividend" terminology does, however, give certain charitable organizations the ability to invest in real estate investments trusts

136. See 1960 Annual Statement of the Krather Corporation.

137. Int. Rev. Code of 1954, § 857(b)(3)(C). To prevent the conversion of short term gains into long term gains through the device of a wash sale, there is a provision stating that a short term loss is deemed to be received with respect to a loss on the sale of a real estate investment trust share held for less than thirty-one days. Int. Rev. Code of 1954, § 857(b)(4) and Treas. Reg. § 1.857-4(c)(3) (1962) contain an illustration of this provision.

free of the taxation which would be required on other rental income.[138]

The net effect of these rules is to produce only a partial conduit. The distribution of only a small part of the cash flow may be required and net operating losses are not given conduit treatment. Undistributed income is taxed at the real estate investment trust level and distributed income, except for capital gains, loses its original quality and becomes ordinary dividend income.

IV. A Major Potential "Loophole": Enterprise Division

The new law may contain a major "loophole." It may permit various enterprises to divide themselves into two parts: a real estate investment trust holding the real estate and a corporate tenant conducting the active business. This would offer potentially huge tax savings for new and/or existing enterprises if recognized by the courts. If a corporate division were permitted for tax purposes, earnings ordinarily taxed at the corporate level could be made safe from taxation by transferring them to the real estate investment trust as rent.[139] The qualifying real estate investment trust would not pay any tax at the entity level since it could distribute as dividends all the rent it received from the corporation to the shareholders.[140]

The device of enterprise division might be utilized in three general business situations: A new business which does not require an independent contractor; an old business which does not require an independent contractor; and a business, old or new, which does require an independent contractor.

A. *New Business Not Requiring an Independent Contractor*

The tax "windfall" of enterprise division is most likely to succeed with new enterprises which do not require the services of an independent contractor. The shareholders would first organize a real estate investment trust to hold the land and buildings of the operation. Next, substantially the same shareholders would organize a corporation to conduct the active business. The trust would then lease the land and buildings to the corporation. The corporation would pay a sum of rent for the use of the property and deduct the rent paid as an ordinary

138. Int. Rev. Code of 1954, § 511; see also Roberts, Feder & Alpert, Congress Approves Real Estate Investment Trusts; Exacting Rules Made, 13 J. Taxation 194, 197 n.63 (1960).

139. E.g., a corporation which owns its own real estate and has a taxable income of $1,000,000 pays approximately $520,000 in corporate income tax. If the same corporation paid the $1,000,000 as rent to a real estate investment trust owned by its own shareholders, it would not pay any corporate tax since rent is deductible. Hence there is a potential doubling of after-tax net income.

140. Int. Rev. Code of 1954, § 857(a)(1).

business expense. The real estate investment trust would "pass-through" the rent income to its shareholders tax-free. Since there is substantial common ownership, the effect is that income derived from an active business has been "passed-through" without a corporate tax.

The amount of rent should be fixed in advance and should approximate the fair market value of the land and buildings. This is necessary in order to prevent the contention that there is profit sharing between the tenant and the trust. Furthermore, since this is an area beyond the ken of legislative purpose, a technical "arms-length" relationship must be stringently adhered to. Also, the corporate tenant must perform any service functions itself.

The assertion that common ownership of a real estate investment trust and a corporation would not disqualify the trust is based on the judgment that the trust is deemed a corporation with respect to the application of the Code's attribution rules.[141] Therefore, the attribution rules will not apply if no shareholder has a ten per cent ownership interest. In addition, it can be argued that Congress was aware of the possibility of common ownership when it prohibited more than thirty-five per cent common ownership of the trust and its independent contractor. The absence of a similar injunction regarding the trust and its tenant militates for the propriety of common ownership. Furthermore, in discussing the reduction from fifty to ten per cent in the applicable attribution rules, the congressional committee report states that:

> This prevents the avoidance of restrictions . . . with respect to rents from real property through the device of setting up a related organization. It also forecloses the opportunity of any substantial relationship between the trust and the business of any tenant.[142]

It might be asserted that this shows that Congress intended that there be no common ownership and that it is a court's duty to interpret the Code provisions in this light. Contra, Congress enjoined only substantial relationship between the trust and *business* of the tenant, not of the trust and the *tenant*. The purpose of the dichotomy is to require the trust to remain a passive investment instrument and this purpose is met when rent is not dependent upon active business. In any event, the method used to "foreclose" substantial relationship was all that was provided, and any contrary interpretation might be difficult.

It has been maintained that a real estate investment trust is to be treated as a corporation with respect to the application of the attribution rules of the Code.[143] But this assertion may equally apply to unfavorable Code sections such as sections 269 and 482.

141. See note 81 supra and accompanying text.
142. H.R. Rep. No. 2020, 86th Cong., 2d Sess. 7 (1960).
143. See note 81 supra and accompanying text.

The language of section 269[144] could be applied to the device of enterprise division. A court might deem the real estate investment trust a "corporation" for purposes of section 269 and deny as tainted the deduction for distributed rent. Alternatively, the tenant corporation might be denied its deduction for rent paid to the trust.[145] On the other hand, the formal "arms-length" relationship might be upheld as proper.[146] It might be that the corporation was acquired for a valid business purpose, the conduct of an active business, and that the real estate investment trust was outside the scope of section 269. The real estate investment trust might also argue valid business purpose and buttress that argument with other investments and activities. While the current cases have been essentially limited to acquisitions of loss corporations, surtax exemptions, transfers of high earning assets, and basis motivated transactions, the judicial development of section 269 is in its early stages, and the applicability of that Code section to enterprise division remains a danger.[147] The possibility of a general law "sham" or "business purpose" attack must also be considered.

Section 482[148] might be deemed to apply to enterprise division if the rent paid by the corporation was greater than the fair market value of the property let. In contrast to section 269, a reallocation under section 482 most likely would require that only a portion of the tax saving of enterprise division be denied. It is unlikely that the Commissioner would allocate all the income to the tenant corporations, although it has been allowed in extreme "sham" situations.[149] The greater danger from

144. Int. Rev. Code of 1954, § 269 reads in part: "If . . . any person or persons acquire, or acquired . . . directly or indirectly, control of a corporation . . . and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such . . . allowance shall not be allowed."

145. While the treasury regulations discuss the creation of two "corporations," they are limited to purposes "to secure . . . multiple surtax exemptions . . . or multiple minimum accumulated earnings credits. . . ." Treas. Reg. § 1.269-3(b)(2) (1962).

146. It might be argued that utilization of new tax provisions is a valid business purpose. I.T. 3757, 1945-1 Cum. Bull. 200 so ruled regarding the formation of a subsidiary to utilize the then new Western Hemisphere Trade Corporation provisions. Int. Rev. Code of 1954, §§ 921, 922. Contra, is the argument of utilization of new tax provisions within versus without the congressional purpose.

147. See generally Barnard, Acquisitions for Tax Benefit, 34 Calif. L. Rev. 36 (1946); Coastal Oil Storage v. Commissioner, 242 F.2d 396 (4th Cir. 1957).

148. Int. Rev. Code of 1954, § 482 reads in part: "In any case of two or more organizations . . . (whether or not incorporated . . .) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income . . . among such organizations . . . if he determines that such . . . allocation is necessary in order to prevent evasion of taxes. . . ."

149. See Aldon Homes, Inc., 33 T.C. 582 (1959).

excessive rent payments is a judgment of profit sharing with the tenant, which could lead to disqualification of the real estate investment trust and loss of all the new law's benefits.[150]

One final danger to enterprise division remains to be considered. It arises from the question of whether an independent contractor is a condition of qualification in a situation where service-type activities are inherent in the tenant's operation. Can the tenant perform its own service-type activities, or must the trust employ an independent contractor? Too, if the trust does not hire one, will the tenant be deemed the independent contractor?[151]

The Code does not explicitly require the employment of an independent contractor in the situation under analysis. The final regulations merely exclude for the seventy-five per cent income test "any amount received . . . if the . . . trust furnishes or renders services . . . other than through an independent contractor. . . ."[152] In form, enterprise division avoids having the trust render services.

The purpose of the independent contractor concept is to assure that the trust remain a passive investment instrument. Enterprise division seems to result in a very passive trust. Furthermore, the "net-lease" of property, where the tenant satisfies most of the owner's obligations, is quite normal. This militates against a finding that "implicit" in the Code provisions is the requirement that an independent contractor be employed when the tenant does not require any outside help. The entire statutory design, which is to exclude actual rents received from services, argues against such a finding. Yet a court struggling with a device beyond the ken of legislative purpose might very well reach such a conclusion. It might be held that an independent contractor must be employed whenever service-type activities are involved, or a court might conclude that the tenant is deemed to be the independent contractor, or that the trust is actually performing services through a "straw" tenant. In any of these situations, the device of enterprise division must fail, since the trust cannot own more than thirty-five per cent of its independent contractor and cannot receive rent for the performance of services.[153]

150. See note 106 supra and accompanying text.

151. If the cost of a contractor and the inherent administrative expenses of enterprise division total less than 52% of the rent paid, some saving might be derived even if an independent contractor is employed.

152. Treas. Reg. § 1.856-4(b)(1) (1962).

153. Some variation in the common ownership of trust and tenant might make enterprise division less vulnerable to judicial reversal. Additional activities for the trust would

Thus the dangers are numerous in effecting a corporate division. Yet, it is submitted that the potential tax benefits may often outweigh the potential risks. The advantage is a large increase in net income after taxes, while the risk may only be legal fees for the certain litigation that will follow. If the litigation is lost, the enterprise is in essentially the same position that it would have been had it started everything in the corporate form, with the exception that a tax bill will have accumulated and some extra income may have been distributed.

B. *Existing Business Not Requiring an Independent Contractor*

The same problems involved in establishing enterprise division for a new business which does not require an independent contractor are evident in the division of an existing business not requiring an independent contractor. The additional problem is the tax consequences of dividing an existing corporation.[154]

An existing corporation might create a real estate investment trust, convey the corporate real estate to it, and distribute the trust shares to the corporate shareholders. The corporation would avoid tax consequences from this transaction by dint of section 351.[155] It is submitted, however, that the shareholders would be liable for a dividend tax on the distribution of the real estate investment trust shares to the extent of the corporation's earnings and profits. Qualification for tax-free treatment under section 355[156] requires that there be two separate businesses involved. There is currently a dispute regarding whether there is a requirement of two active businesses before the division as well as after.[157] But it seems established that a taxpayer cannot divide rental property from an operating business if it did not constitute a five-year business at the time of division, even though the rental property would comprise an active business after the division.[158] Also, the corporate

be wise. Also, reciprocally organized divided enterprises, with each tenant paying rent to the real estate investment trust of the other, might be investigated.

154. Enterprise division for existing corporations would only involve previously discussed problems if the trust restricted itself to property acquired after its creation.

155. Int. Rev. Code of 1954, § 351.

156. Int. Rev. Code of 1954, § 355 reads in part: "If . . . a corporation . . . distributes to a shareholder, with respect to its stock . . . all of the stock and securities in the controlled corporation held by it immediately before the distribution . . . then no gain or loss shall be recognized to . . . such shareholder or security holder on the receipt of such stock or securities."

157. Compare Treas. Reg. § 1.355-1(a) (1955), with Coady v. Commissioner, 33 T.C. 771 (1960), aff'd mem., 289 F.2d 490 (6th Cir. 1961).

158. Appleby v. Commissioner, 35 T.C. 755 (1961), aff'd mem., 296 F.2d 925 (3d Cir.),

reorganization sections require a "business purpose" which might be difficult to sustain in this situation.

A partial liquidation might be an alternative method to effect the enterprise division of an existing corporation. The corporation would distribute the real property to its shareholders in a purported partial liquidation under section 346.[159] The shareholders would only undergo capital gain treatment if a valid corporate contraction could be established. The shareholders could then establish a real estate investment trust which would hold the real estate and rent it to the corporation and so forth. But section 346(b) would not be available, because that section incorporates the same concept of two active businesses contained in section 355.[160]

The concept of genuine corporate contraction is cloudy, but since the distribution would be pro rata to the shareholders, it seems that section 346(a)(2) would also not be available.[161] The sanction for failure to qualify under section 346 would be ordinary dividend treatment for the shareholders.

It might further be suggested that the corporation redeem in full the stock of some of the shareholders.[162] These former shareholders would then form a real estate investment trust and purchase the real estate from the corporation with amounts received in the redemption. The redeemed shareholders and the corporation would undergo capital gains treatment. Even if this survives attack as a "sham," there are obvious business problems and the essential substance of corporate division has been lost.

Thus, in an enterprise division of an existing corporation, it is quite likely that a dividend tax will have to be paid by the shareholders to the extent of the corporation's earnings and profits. This expensive consequence will dissuade most existing corporations from attempting a corporate division. It may be warranted if the corporation is devoid of earnings and profits, or if some method can be devised to avoid taxation. Otherwise, it is unlikely that there will be many corporations sufficiently hardy to effect dividend treatment for their shareholders in order to "buy" a law suit. Most existing corporations should, therefore, wait until this area has been further charted.

cert. denied, 370 U.S. 910 (1962); Treas. Reg. § 1.355-1(c)(2) (1955). See also Rev. Rul. 59-400, 1959-2 Cum. Bull. 114.

159. Int. Rev. Code of 1954, § 346.

160. Treas. Reg. § 1.346-1(c) (1955). See note 158 and accompanying text.

161. See Chandler v. Commissioner, 22 T.C. 1158 (1954), aff'd, 228 F.2d 909 (6th Cir. 1955) (per curiam).

162. Int. Rev. Code of 1954, § 302.

C. *Business Requiring an Independent Contractor*

Previously it was asserted that common ownership of a real estate investment trust and a corporate tenant, while risky, is not literally violative of the statute. In those situations, it is the tenant and not an independent contractor who is performing any and all service-type activities. In a multiple tenant situation, however, an independent contractor will usually be necessary. Office buildings and hotels will usually require independent contractors to provide services. In these situations, there will be no "tenant" which can perform the services for itself. Common ownership will therefore be barred because of the thirty-five per cent rule preventing substantial common ownership of the trust and the independent contractor.[163]

The thirty-five per cent rule does not literally prevent the situation where a real estate investment trust would rent to a "tenant" who would in turn "sublet" the premises. The original tenant would perform the services that an independent contractor would perform. Provided that no shareholder of the tenant owned ten per cent of the trust, the attribution rules presumably would not apply and the real estate investment trust would not be deemed to own the tenant. Hence, it would not receive any disqualifying income from the tenant. This manipulation, however, would most likely be pierced by the courts. In the multiple tenant situation various services must be performed, and calling the person who performs them "tenant" should not change the substance of the situation. Also, state laws which provide that a "guest" at a hotel is not a "tenant" should not change the result.

Hence, in the situation where it is contemplated that there will be a disparate group of tenants, such as an office building or a hotel, it appears unlikely that the enterprise division device can be utilized.

V. Regulation

Real estate investment trust legislation was ostensibly prompted by a desire to give small investors an opportunity to derive income from real property interests. The inapt analogy of regulated investment companies was offered in support of this concept. Yet the parallel has not been extended to the one area in which it has merit: the need for some form of operational regulation. It is submitted that legislation similar to the Investment Company Act of 1940 should be enacted.

Real estate is a narrow field which requires very technical expertise. The average investor will not usually have this expertise. He must,

163. See note 116 supra and accompanying text.

therefore, place great reliance on the trustees of a real estate investment trust. The absence of operational regulation creates a potentially dangerous situation where the fraud or incompetence of unregulated trustees could result in great loss. "[O]ver the years real estate has probably lost money for a larger percentage of investors than any other single form of financial venturing. . . ."[164]

Furthermore, deceptively high offers of approximately a twelve per cent "return" are not rare for real estate syndications[165] and, presumably, trusts. Such offers induce the entry of unsophisticated small investors. These investors do not realize that the "return" is in part, a refund of capital. Often they do not comprehend that the trust will have to invest in risk enterprises in order to maintain a high percentage of profit.[166]

Moreover, there may be intense promotion of certain real estate investment trusts. Witness the promotion of regulated investment companies and the problems there arising even though they are regulated. Promotion may be intense because there is a large profit potential for promoters: they can sell property they own to the trust for an unregulated amount; they can become the independent contractor for an unregulated compensation; their associates can become trustees of the trust for an unregulated remuneration; their law firms can earn unregulated fees; their associates can become investment advisors at unregulated salaries, and so forth.[167]

Finally, investment in real estate investment trusts is inherently "glamorous." These trusts are congressionally induced entities specifically designed to provide tax benefits for small investors. For the first time, a freely transferable tax-free conduit, which might even be traded on a stock exchange, is available. It may not be too surprising if the small investor joins with something less than dispassionate analysis.

164. C. G. Haynsworth, N.Y. World Telegram and Sun, April 10, 1961, p. 27, col. 3.

165. For a discussion of real estate syndicates see Berger, Real Estate Syndication: Property, Promotion, and the Need for Protection, 69 Yale L.J. 725 (1960); Comment, Real Estate Syndication, 30 Fordham L. Rev. 440 (1962).

166. "Today . . . returns of over 7 or 7½ percent cannot be paid on real estate equities with safety. . . . Unfortunately, the . . . psychology is being built up. . . ." Charles Noyes, N.Y. World Telegram and Sun, Dec. 28, 1960, p. 19, col. 1.

167. See, e.g., the following advertisement: "SOMETHING NEW HAS BEEN ADDED . . . ANNOUNCING . . . FIRST REAL ESTATE INVESTMENT TRUST FUND . . . Organized Especially to Qualify for the Tax Benefits of the New Federal Law Which Grants Tax Exemptions . . . REAL ESTATE SYNDICATE INVESTMENT HAS IN THE PAST AFFORDED DISTRIBUTIONS TO ITS OWNERS AT THE RATE OF APPROXIMATELY 10% OR MORE PER ANNUM . . . Special Tax Advantages available for the first time. . . ." N.Y. Times, Jan. 15, 1961, § 8, p. 5R, col. 1-3.

Several states already have regulatory legislation applicable to real estate investment trusts. New York, for example, enacted a statute in 1960, following a real estate syndication scandal. That disgrace involved a syndicate formed to purchase and lease-back a hotel to the promoters. Large percentage returns were offered and an abundance of small investors participated. The venture became insolvent, but it was hidden from the investors, and funds from the promoter's other ventures were commingled. Eventually the whole edifice toppled, the promoters were indicted, and the investors were bilked.[168] In addition to incompetence, the promoter's fees were exorbitant and the lease-back was overly favorable to the promoter-lessees. Attempts were made by the real estate syndicators to form a self-regulating body, but, in spite of these attempts, the New York legislature passed a bill which comprehends both syndicates and real estate investment trusts.[169] This act requires prior State approval of a prospectus and contains comprehensive restrictions on false offering and advertising. But this statute only provides for full disclosure of the facts of an investment. It does not contain regulations regarding investments, management fees and the like.[170]

The relevant federal regulatory statutes are the Securities Act of 1933[171] and the Investment Company Act of 1940.[172] It is submitted that the 1933 act, which is essentially a full disclosure type statute, will apply to real estate investment trusts. The real estate investment trust requirement of 100 shareholders most likely precludes use of the private offering exemption of the 1933 act. The intrastate exemption of the 1933 act also appears inapplicable since the scope of a realty trust, together with the transferability of shares, makes reliance on it risky. The Securities and Exchange Commission is proceeding under the assumption that the 1933 act will apply to real estate investment trusts, and has published a Form S-11 for registration of "certain real estate companies." While the 1933 act requires full disclosure, it does not contain provisions which regulate trust operations.

There is some question regarding the applicability of the Investment Company Act of 1940, but it probably will not be applicable to most real estate investment trusts. A real estate investment trust will usually be able to qualify for an exception to the 1940 act, since most trusts will be primarily engaged in purchasing and acquiring interests in real

168. See Berger, supra note 165.

169. N.Y. Gen. Bus. Law §§ 352e-52j.

170. See Real Estate Investment Trusts, California Department of Investment, Division of Corporations Bull., art. 18-1, § 549-52.1 (Feb. 25, 1962).

171. 48 Stat. 74, as amended, 15 U.S.C. §§ 77a-z (1958) (Supp. III, 1959-1961).

172. 54 Stat. 789, as amended, 15 U.S.C. § 80a (1958).

estate and will not be in the business of issuing face amount certificates of periodic payment.[173] The Securities and Exchange Commission is not administering the 1940 act to comprehend real estate investment trusts.[174] Furthermore, it would not be feasible to apply many of the provisions of the 1940 act to real estate investment trusts since the act's provisions were drafted to apply only to a specific type of entity, namely, a security investment company.

Thus the only current federal regulation is of the disclosure type. The committee reports on the real estate investment trust are silent on the subject of regulatory statutes. Perhaps the draftsmen believed that the active regulation of the 1940 act would apply, but it is submitted that it does not.

What type of regulation is needed? Since the promoters of real estate investment trusts will usually have to apply for permits to issue securities, the attitudes of the state corporation commissioners are important. The Midwest Securities Commissioners Association composed of sixteen state commissioners[175] has unanimously adopted a statement of policy regarding real estate investment trusts.[176] The commissioners require a mimimum of three trustees to be elected for a term not to exceed three years; such trustees can be removed by a two-thirds vote of the shareholders.[177] No assets can be acquired from trustees, officers, independent contractors or any other interested party except at the inception of the trust.[178] Profit by "such person" on disposition of trust assets is prohibited.[179] The trust instrument must be recorded and it may not contain provisions relieving the trustees from liability for negligence.[180] There can be no change in the declaration of trust or other basic instruments without a two-thirds vote of the shareholders.[181] There is a required

173. See 54 Stat. 789(3)(c)(6)(C), as amended, 15 U.S.C. § 80a-3(3)(6)(C) (1958).

174. "On the basis of the information presently available, it appears likely that most real estate investment trusts will qualify for the exception from the definition of investment company contained in Section 3(c)(6)(C) of the Investment Company Act." Letter From Mr. Abraham Raizen, Assistant Director of the Securities and Exchange Commission, to Mr. Theodore Lynn, March 31, 1961.

175. The members are: Arizona, California, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, New Mexico, North Dakota, Oklahoma, Tennessee, Texas, and Wisconsin.

176. Revised Midwest Securities Commissioners Association Statement of Policy Regarding Real Estate Investment Trusts, Illinois Securities Division Bull., No. 101 (Supp., Oct. 27, 1961).

177. Id. at § B(1)(a)-(d).

178. Id. at § B(1)(b).

179. Ibid.

180. Id. at §§ E, B(1)(c).

181. Id. at § B(9).

minimum capital of $100,000 and disclosure requirements respecting the properties, investment policy and limitation of liabilities of the beneficiaries.[182] There must be an annual meeting and yearly reports must be sent to the shareholders and the securities commissioner.[183] All distributions must be accompanied by a statement of source.[184] Finally, the trust must be terminable at any time by a two-thirds vote of the shareholders.[185]

The commissioners would also place stringent restrictions on investment advisors. Any investment advisory contract is limited to one year and any trustee or interested party is prohibited from acting in such capacity.[186] The compensation of the investment advisor is limited to one half of one per cent of the net assets of the trust based on an adjusted basis or on the fair market value, whichever is less.[187] Copies of all contracts with independent contractors must be filed with evidence that the fees are in accord with prevailing costs.[188] There is also a gross limitation of $5,000 or one per cent of the average net assets, whichever is greater, on "expenses of every kind" excluding interest, taxes, maintenance, independent contractor compensation, investment advisor fees and reasonable sales commissions.[189] Finally, there is a requirement that the consideration paid for real property by the trust shall "ordinarily be based upon the fair market value of the property as determined by a real estate appraisal prepared by a qualified, disinterested, independent appraiser."[190]

The commissioners' report also contains a list of prohibited activities. No trust shall invest in unimproved properties or in any mortgage on such properties. No investment in any mortgage other than a first mortgage is permitted, nor is investment in any mortgage for a greater percentage of value than permitted under local law to savings and loan associations allowed. The trust is prohibited from investing more than one per cent of its assets in real-estate contracts of sale or in property subject to a mortgage which is not held by an institutional lender, and then only if the debt is not greater than fifty per cent of the fair market value of the property as computed by an independent appraiser. The

182. Id. at §§ C, B(2)-(3).
183. Id. at § B(4)-(5).
184. Id. at § B(8).
185. Id. at § B(10).
186. Id. at § B(11).
187. Ibid.
188. Id. at § D.
189. Id. at § B(12)(b).
190. Id. at § B(13).

trust is barred from borrowing, unsecured, more than eight per cent of the net value of the net assets or from encumbering any of its property for more than two thirds of its fair market value. Lastly, a trust may not engage in any short sale or issue redeemable securities or securities of more than one class.[191]

These suggestions should not be accepted without intensive study, if at all. They seem overly restrictive and involved. Some seem to run counter to the policy and procedure of the real estate investment trust law. The statement of policy does, however, provide a guide to the relevant areas of concern. It is submitted that there is a need for moderate uniform national legislation regulating the conduct of real estate investment trusts.

VI. Regulated Investment Companies: The Inapt Analogy

It has become clear that the real estate investment trust law does not guarantee most of the benefits envisioned for the small investor. The only other ground for the law was the analogy to regulated investment companies. It is submitted that this is an inapt analogy. Consider the magnitude of tax savings. A nonqualifying realty trust would pay $52 in taxes for every $100 of net taxable income while, in contrast, a nonqualifying security investment company would still have the benefit of an eighty-five per cent intercorporate dividend deduction. It would pay only $7.80 in taxes since only $15 of every $100 of income would be subject to tax. Therefore, the new legislation has granted real estate investment trusts $52 for every $100 of income while regulated investment company legislation has only provided a $7.80 saving for every $100 of income.[192]

This distinction is also applicable when the economic production of income is viewed. The rent that a real estate investment trust receives has never been taxed before. But the dividends that a regulated investment company receives have already been taxed at the producing corporation level. The realty trust saves $52 for every $100 of income. The security investment company only receives $48 for every $100 of producing corporation income. If the security investment company did not qualify for a tax saving, it would pay only $3.74 in taxes, since the eighty-five per cent intercorporate dividend deduction would still be available. Hence, viewing the economic production of income, the realty

191. Id. at § B(14).

192. The disparity does not exist to the extent that regulated investment companies obtain interest and capital gains income. The major portion of their income is, however, derived from dividends.

trust is granted a saving of $52 for every $100 of income while the security investment company saves but $3.74.

In vetoing an earlier attempt to gain special treatment for realty trusts, President Eisenhower viewed the distinction from another perspective.[193] His veto message noted that in the absence of special tax treatment, security investment companies would be taxed three times. They would be taxed at the producing corporate level, at the security company level to the extent that the eighty-five per cent deduction is unavailable, and at the shareholder level. Realty trusts would be taxed but twice. They would be taxed at the entity level and at the shareholder level, as is the normal corporate procedure.[194]

Furthermore, the regulated investment company is qualitatively required to be a "passive" investment conduit while the real estate investment trust is only passive in degree. The security investment company may only invest in already existing corporations. Realty trusts may develop land, supervise construction, engage in unregulated borrowing, choose tenants, mortgage the properties and undertake an unlimited number of projects. The realty trust can, therefore, comprise far more active conduct of business than can a security investment company. Also, security investment companies merely siphon investment into the basic economy, while realty trusts may siphon more investment into real estate than is desirable for national growth.

Moreover, real estate investment trusts provide a greater danger for the small investor than do security investment companies. Security companies are actively regulated, while realty trusts are not.[195] Security investment companies are by their very nature liquid while realty trusts will hold large amounts of fixed assets. The real-estate assets will be mortgaged. In the event of adversity the realty trust investor might lose everything. Contrast the liquidity and outright ownership of assets in security investment companies. Furthermore, regulated investment companies must diversify their investments, while real estate investment trusts can put all their assets into one property.

In view of these numerous differences, the analogy between the regulated investment company and the real estate investment trust appears inapt and, hence, is a weak justification for the new law.

VII. Conclusion

The real estate investment trust is but one facet of the general problem of business entity taxation and as such, it is an additional tier on a

193. See notes 51 & 52 supra and accompanying text.

194. Ibid.

195. See notes 168, 172 & 174 supra and accompanying text.

"crazy-quilt" system. While the original stimulus for the law was provided by a small class, the final product can be utilized in a broad area. The law may even contain a major "loophole" which would allow enterprise division and unjustified tax "windfalls." While exceedingly lengthy and technical, the law is deficient in many areas where restriction and regulation seem necessary. It is thus theoretically unjustified, pregnant with possibilties of abuse, and, ironically, more likely to harm than help the small investor for whom it was ostensibly created.