

## Real Estate Investment Trusts—Equalization of Investment Opportunity or Unjustified Tax Break to Favored Interests?

A recent amendment to the Internal Revenue Code provides a tax benefit to those who invest in real estate through the medium of a trust or an association. A real estate investment trust, which meets the conditions set forth in the act, is allowed special deductions from its taxable income. These deductions provide a partial "conduit" for investment income of the trust, treating the distributions to the beneficiary as direct investment income similar to distributions from regulated investment companies.<sup>1</sup> The purpose of this note is to examine the "stated purposes" of this legislation, with a view to ascertaining its real potential, its desirability and whether these "stated purposes" will be fulfilled.<sup>2</sup>

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1. 74 Stat. 998 (1960), Int. Rev. Code of 1954, §§ 856-58. This amendment was enacted as Pub. L. No. 779, approved Sept. 14, 1960, 86th Cong., 2d Sess. (1960).

2. Real Estate Investment Trust Requirements: A) Definition. The requirements are here generally stated without detailed exploration of all the various possible ramifications. Real estate investment trust is defined as: "an unincorporated trust or an unincorporated association, . . . managed by . . . trustees," having "transferable shares . . . , which (but for the provisions of this part) would be taxable as a domestic corporation"; not holding "any property primarily for sale to customers in the ordinary course of its trade or business. . . ." The beneficial ownership must be held by 100 or more persons for 335 days of the taxable year, or a proportionate part thereof. Int. Rev. Code of 1954, §§ 856(a) (5), 856(b). Beneficial ownership must be so distributed that it "would not be a personal holding company . . . if all of its gross income constituted personal holding company income." Int. Rev. Code of 1954, §§ 542, 543, 856(a) (b). In other words, at no time during the last half of the trust's taxable year may five or fewer individuals, directly or constructively, own more than 50% of the trust. Int. Rev. Code of 1954, § 542(a) (2). The broad rules of constructive stock ownership in § 544 apply. The trust must fulfill these requirements for the entire taxable year and an election made to be taxed as a real estate investment trust. Int. Rev. Code of 1954, § 856(e) (1).

B) Investment Restriction. At least 75% of the "value" of its total assets must be represented by "real estate assets, cash and cash items (including receivables), and Government securities. Int. Rev. Code of 1954, § 856(c) (5) (A). "Real estate assets" are defined as real property and interests in real property and mortgages on real property and beneficial ownership in other real estate investment trusts. The trust cannot invest more than 25% of its total assets in securities other than the securities that fall within the 75% requirement. Diversified security investment is required; to wit: the trust cannot have more than 5% of its total assets invested in any one issuer, nor can the trust hold more than 10% of the outstanding voting securities of an issuer. Int. Rev. Code of 1954, §§ 856(c) (5) (A), (B). Allowance is made for fluctuations in value of the assets of the trust. A trust meeting the investment requirements at the end of a quarter is not dis-

Investment trusts have been used as a medium of common investment in the United States since the latter part of the 19th century.<sup>3</sup> Smaller investors could collectively invest, thereby achieving diversi-

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qualified because of a discrepancy during a subsequent quarter, "unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition." If the failure to meet the requirements at the end of a quarter is due to a purchase in that quarter, the trust "shall not lose its status for such quarter as a real estate investment trust if such discrepancy is eliminated within 30 days after the close of such quarter. . . ." Int. Rev. Code of 1954, § 856(c)(5).

C) Gross Income Requirements. Gross income requirements are imposed which limit the trust's investments to "passive" real estate investments. First, at least 90% of the trust's gross income must be derived from dividends; interest; rents from real property; "gain from the sale or other disposition of stock, securities and real property" and "abatements and refunds of taxes on real property." Second, 75% of the gross income must be derived from:

(A) rents from real property; (B) interests on obligations secured by mortgages on real property or on interests in real property; (C) gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property); (D) . . . distributions on and gain from the sale or other disposition of, transferable shares [of beneficial interest] . . . ; and (E) abatements and refunds of taxes on real property. Int. Rev. Code of 1954 § 856(c)(2), (3).

"Rents from real property" under the 90% and 75% income requirement exclude rents that are based, either in whole or in part, upon a percentage of the income or profits derived by the lessee from the property. Rents are also excluded if received from a corporation in which the trust owns 10% or more of the total combined voting power of all classes of stock, or, if a person, if the trust has an interest of 10% or more in the assets or profits of such person. Int. Rev. Code of 1954, § 856(d)(2). The rules of constructive stock ownership in 318 apply, except that 10% is substituted for 50% in § 318(a)(2)(C).

The third limitation on the income of the trust is that less than 30% of the trust's gross income must be derived from the sale or other disposition of "(A) stocks or securities held for less than 6 months; and (B) real property (including interests in real property) not . . . involuntarily converted . . . [and] held for less than four years." Int. Rev. Code of 1954, § 856(c)(4). See § 1033 for definition of involuntary conversion.

(D) Taxation of the Real Estate Investment Trust. A qualified real estate investment trust which distributes 90% or more of its taxable income, exclusive of net long-term and short-term capital gains, for the taxable year is entitled to the tax benefits prescribed in the Act. Distributions from earnings are taxed to the distributees with a corresponding dividend paid deduction allowed to the trust. Int. Rev. Code of 1954, § 857(a)(2). A trust which meets the distribution requirement is still taxed at the corporate rate on its "real estate investment trust taxable income." Int. Rev. Code of 1954, § 857(b)(1). (Emphasis added.) The "taxable income" is determined after the following adjustments are computed: the exclusion of the net long-term capital gain over the net short-term capital loss if any, and a deduction of dividends paid, computed without regard to capital gains dividends. Int. Rev. Code of 1954, § 857(b)(2)(A); see § 858(a). Int. Rev. Code of 1954, § 857(b)(2)(B). A separate 25% tax is imposed on the excess of the trust's net long-term capital gain over the sum of the trust's net short-term capital loss

fied investment holdings plus expert investment counsel otherwise available only to investors of substantial wealth.<sup>4</sup> Tax treatment of the two types varied in the early days of the income tax, but by 1936

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and its deduction for dividends paid, determined with reference to capital gains dividends only. The normal corporate deductions for net operating loss and for dividends received are not deductible from the taxable income of real estate investment trusts. Int. Rev. Code of 1954, §§ 172, 243-47.

(E) Taxation Beneficiaries. The tax imposed upon a beneficiary of a real estate investment trust for the distributions of the trust is similar to the tax on stock dividends. The principal exception from the normal tax treatment is the provision for capital gain dividends. The capital gain dividend is taxable "as a gain from the sale or exchange of a capital asset held for more than 6 months." Int. Rev. Code of 1954, § 857(b)(3)(B). A capital gain dividend

is any dividend, or part thereof, which is designated by the real estate investment trust as a capital gain dividend in a written notice mailed to its shareholders . . . at any time before the expiration of 30 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the trust . . . is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated. Int. Rev. Code of 1954, § 857(b)(3)(C).

However, if a beneficiary acquired his interest within 30 days prior to the distribution of a capital gain dividend, any loss on the subsequent disposition of his interest is treated as a long-term capital loss to the extent of such dividend. Int. Rev. Code of 1954, § 857(b)(4). The test for determining ownership for more than 30 days is that of § 246(c)(3).

Two other exceptions to the normal tax on stock dividends should be viewed. Neither the 4% dividends received credit nor the \$50 exclusion allowed an individual is permitted. Int. Rev. Code of 1954, §§ 34(a), 116. The 85 per cent deduction on dividends received by corporations is not applicable to real estate investment trust distributions. Int. Rev. Code of 1954, §§ 243, 857(c).

(F) Current Earnings Problem. If a real estate investment trust fails to meet the distribution requirement, it would then be taxed as a corporation, and the beneficiaries taxed as shareholders. Int. Rev. Code of 1954, § 857(a). The disadvantage in this is that the current earnings and profits of a trust, but not the accumulated earnings and profits, may "not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year." Int. Rev. Code of 1954, § 857(d); see generally, § 857(b)(2). The election to be taxed as a real estate investment trust carries over to subsequent years, and is probably irrevocable. Int. Rev. Code of 1954, § 856(c)(1). Thus, the trust could have a distribution classified as a dividend when the capital loss for the year equalled the trust's income for that year. For example, if the trust has no accumulated earnings and profits, but has income of \$50,000, and it distributes \$10,000 to its beneficiaries, the distribution is a dividend as the capital loss does not reduce current earnings and profits. Int. Rev. Code of 1954, §§ 857(d), 857(b)(2). The trust, however, could avoid this by failing to meet one of the requirements necessary for real estate investment trust status and then be treated as an association taxable as a corporation. Int. Rev. Code of 1954, § 856.

In addition to the requirements specified in Sections 856-858 the trust may be

the situation had become established so that income from a public investment trust was taxed as corporate income<sup>5</sup> and distributees of the income were taxed personally.<sup>6</sup>

In 1936, regulated open-end mutual investment companies were the recipients of some relief in the form of a deduction for distributed profits from their taxable income.<sup>7</sup> The Revenue Act of 1942 ex-

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required to file a registration statement under the Securities Act of 1933, 48 Stat. 74 (1933), 15 U.S.C. 77a-77aa, and comply with regulatory provisions of the Securities Exchange Act of 1934, 48 Stat. 881 (1934), 15 U.S.C. §§ 77b-78y, (for example: Broker-dealer Registration). Furthermore, compliance with the Investment Company Act of 1940, 54 Stat. 789 (1940), 15 U.S.C. §§ 80a-1a to 80a-52, and the Trust Indenture Act of 1939, 53 Stat. 1149 (1939), 15 U.S.C. §§ 77aaa-77bbb, may be required. The trust must also consider the Blue-Sky statutes in states where the ownership certificates are to be sold and the trust law in states where the trust plans to hold property. Statutory regulation of business trusts varies to some noticeable extent from state to state and in many states is uncertain and lacking in precedent. See, e.g., 1 CCH Blue Sky Reporter, ¶ 4751-57 (1961); Rohrllich, Organizing Corporate and Other Business Enterprises 177-78 (1958).

3. Kilpatrick, Real Estate Investment Trusts, in 3 House Committee on Ways and Means, Tax Revision Compendium, 1697-98 (1959).

4. *Ibid.* Williamson, Realty Investment Trusts Poised for Launching, The Commercial and Financial Chronicle, Oct. 6, 1960, p. 14.

5. Int. Rev. Code of 1939, § 3797(a) (3), 49 Stat. 1706 (now Int. Rev. Code of 1954, § 7701(a) (3)).

6. Int. Rev. Code of 1939, § 22(a), 49 Stat. 1706 (now Int. Code of 1954, § 61(a)).

7. Prior to the new amendment, trusts were taxed as associations. See *supra* notes 3 & 4. Hence Congress has not defined the term "association," apparently content to leave this to judicial interpretation, and to a lesser degree to Treasury policy. See Revenue Act of 1938 and prior history, and 7 Mertens, Law of Federal Income Taxation, § 38A.01 (1956). Initially, investment trust beneficiaries were considered as not being associated, and, therefore, the association was not considered by the courts as unincorporated corporate equivalents. The reason given was that they lacked direct control over the trust funds. *Crocker v. Malley*, 249 U.S. 223 (1919). In 1924, the Supreme Court held trusts, whose trustees perform similarly to corporate directors while engaged in active business enterprises, taxable as a corporation. *Hecht v. Malley*, 265 U.S. 144 (1924). The Treasury Regulations agreed, stating that real estate trusts actively engaged in a business enterprise were taxable as corporations. Passive trusts were excluded. 4 Cum. Bull. 11; I. t. 1584, 11-I Cum. Bull. I (1923).

In 1935, the question of the tax liability of a real estate investment trust was again considered by the Supreme Court. The trust in question was organized for the purpose of purchasing, developing, operating and selling real estate. The trust formerly operated a country club on land it had developed, but during the tax year in question it had merely held and rented property. The Court said that the character of the organization was to be determined by the purpose and powers stated in the trust instrument and not by the activities pursued. The Court ignored the passive-active trust distinction holding that trusts organized for profit making purposes by its beneficiaries with an organizational structure substantially

tended the tax benefits, liberalized the qualifying requirements and included closed-end investment companies.<sup>8</sup> Special tax treatment is still afforded to qualified mutual investment companies.<sup>9</sup> Recently, annual attempts<sup>10</sup> have been made in Congress to remove the so-called discrimination against the real estate investment trusts in the form of a deduction for distributed profits from their taxable income. In 1956, such a bill was passed by both houses of Congress but vetoed by the President.<sup>11</sup> In 1960, the House, during the regular session of Congress, passed a bill to provide special tax relief.<sup>12</sup> The Senate passed, in special session, as an amendment to an omnibus bill, a bill identical to that of the House.<sup>13</sup> After approval by the House it was sent to the President. This time the President reversed his previous position and signed the bill.<sup>14</sup>

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similar to that of a corporation, taxable as a corporation. *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

The effect of the *Morrissey* decision was to place active and passive public investment trusts into the "association" classification. This had little impact on investment trusts specializing in security investments, since no tax was imposed on dividends received by one domestic corporation from another until 1936. Revenue Act of 1935, ch. 829, § 102(b), 49 Stat. 1015.

Revenue Act of 1936, ch. 690, § 12(a), 49 Stat. 1653; § 48(e), 49 Stat. 1669. A mutual investment company is defined as, "Any corporation (whether chartered or created as an investment trust, or otherwise) . . . if . . . it is organized for the purpose of, and substantially all its business consists of, holding, investing, or reinvesting in stock or securities."

An open-end company is one which is offering or has outstanding any "redeemable security"—defined as a security which entitles the holder on demand to receive approximately his proportionate share of the issuer's net assets or its cash equivalent. I Loss, Securities Regulation 145 (2d. ed. 1961).

8. Revenue Act of 1942, ch. 619, §§ 361-62, 56 Stat. 878. "Closed-end companies do not have redeemable securities; they may occasionally offer new securities to the public as any industrial company does, but the usual way to acquire their shares is on the open market." I Loss, Securities Regulation 146 (2nd ed. 1961).

9. Int. Rev. Code of 1954, §§ 851-56.

10. H.R. 3985, H.R. 3477, H.R. 2992, 86th Cong., 1st Sess. (1959); H.R. 8102, H.R. 3868, H.R. 3780, 85th Cong., 1st Sess. (1957).

11. H.R. 4392, 84th Cong. 2d Sess. (1956), passed both houses of Congress but was vetoed by President Eisenhower. In a memorandum of disapproval, the President gave two reasons for the veto: one, that there is no existing tax inequality as regulative investment companies have two tiers of taxation as do real estate investment trusts. Second, that although the provision is intended to be applicable only to a small number of trusts, it could be available to real estate companies which have always carried on their activities as fully taxable corporations. 102 Cong. Rec. 15304 (1956).

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

13. H.R. 10960, 86th Cong., 2d Sess. (1960). The only difference between the two bills was a clerical amendment. This became P.L. 86-779 by a Senate Floor Amendment.

14. The President signed the bill on Sept. 14, 1960. No reason was given for

I. SPECIAL TAX TREATMENT OF R.I.T.—  
DESIRABLE OR UNDESIRABLE?

The House Ways and Means Committee gave two reasons for the desirability of this real estate investment trust legislation.<sup>15</sup> First, equality of tax treatment between the beneficiaries of real estate investment trusts and the shareholders of regulated investment companies is desirable since in both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources. . . .<sup>16</sup>

Second, the "committee believes it is also desirable to remove taxation to the extent possible as a factor in determining the relative size of investments in stocks and securities on one hand, and real estate equities and mortgages on the other."<sup>17</sup>

If the Committee meant by the first reason that the legislation is desirable because it allows the income of an individual investing through a trust to be taxed in the same manner that the investment income of a direct investor in real estate is taxed, then a strong argument can be made in support of the committee's position. If the trust is passive, limiting its activity solely to investing in real estate, then its beneficiaries are engaged in substantially the same activity as the passive direct investor in real estate. In an equitable sense there does not seem to be any justification for imposing a tax on the medium through which investment equality is achieved which thereby destroys, to a large degree, the equality of investment opportunity that the trust affords the investor of limited means.

However, if the Committee meant that the legislation is desirable because it eliminates the discrepancy existing in the tax treatment afforded the regulated investment company when compared to the

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the reversal in his position. In 1959, the Treasury Department stated that it was no longer opposed to conduit treatment for real estate investment trusts, providing that such treatment was limited to "passive income." The Treasury opposed H.R. 3985, H.R. 3477, 86th Cong., 1st Sess. (1959), as these allowed the trust to render services to the lessee through independent contractors. This, the Treasury felt did not limit the "conduit treatment" to "passive" investment trusts. Letter from David A. Lindsay, Assistant to the Secretary of the Treasury, to Wilbur D. Mills, Chairman, House Ways and Means Committee, August 26, 1959, copy on file Washington University Law Library. Int. Rev. Code of 1954, § 856(d) (8) contains the independent contractor provision that the Treasury found objectionable.

15. H.R. Rep. No. 2020, 86th Cong., 2d Sess. (1960), accompanying H.R. 12559, 86th Cong., 2d Sess. (1960). The trust legislation was passed as H.R. 10960, 86th Cong., 2d Sess. § 10 (1960), but it merely incorporates H.R. 12559, 86th Cong., 2d Sess. (1960). There was no committee report on H.R. 10960, 86th Cong., 2d Sess. § 10 (1960).

16. H.R. Rep. No. 2020, 86th Cong., 2d Sess. 3 (1960).

17. *Id.* at 4.

real estate investment trust, then the reasoning is erroneous. Admitting the structural similarity of the two media, there is a basic difference in the source of income between the two, which, without conduit treatment, are taxed differently. The realty trusts derive income generally from rents and mortgages, the investment company from dividends and interest on corporate bonds. Dividends are paid from the corporate income after payment of the corporate tax by the distributing corporation. Moreover, the tax on dividends received by a corporation from stocks held in other corporations is only fifteen per cent.<sup>18</sup> Thus, a major portion of the income of regulated investment companies is taxed prior to distribution to the company; and the conduit tax provision, insofar as dividends are concerned, costs the government a maximum of 7.8 per cent of the dividend income of the regulated investment companies.<sup>19</sup> Commercial rents and interest on mortgages are expenses of taxpayers which are fully deductible,<sup>20</sup> and taxable as income to corporate recipients. The conduit provision for realty trusts allows this income to completely escape the corporate tax if it is distributed in the year received. The realty trust conduit is therefore costing the government fifty-two per cent on all the distributed income of the trust.<sup>21</sup>

If the income of regulated investment companies and realty trusts were taxed in the same manner prior to distribution to the beneficial owners,<sup>22</sup> the initial tax similarity does not necessarily warrant continued tax equality. Tax exceptions or benefits are used in an attempt to encourage a particular activity deemed to be in the public interest. An exception to the tax code for the purpose of stimulating investments in one sector of the economy should not necessitate the same tax treatment for all forms of investment. Real estate and stocks and bonds are separate and independent areas, and the tax treatment of each should be based upon its own merits and needs, rather than upon superficial structural similarities.

The second reason given by the House Ways and Means Committee for the legislation, that of increasing the amount of investment capital

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18. Int. Rev. Code of 1954, §§ 241-47.

19. The tax on taxable income of a corporation is limited to 52%. Int. Rev. Code of 1954, § 11. The tax on income from dividends received therefor is 52% of 15%. Int. Rev. Code of 1954, § 243. This percentage would be less if the corporation's income did not exceed \$25,000.

20. Int. Rev. Code of 1954, §§ 162(a)(3), 163. Non-business rents however are not deductible.

21. The tax would be only 30% if the corporation's taxable income did not exceed \$25,000. Int. Rev. Code of 1954, § 11.

22. The House Committee on Ways and Means contends that this is the case since the interest income of regulated investment companies is a deductible expense of the payor. H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960).

for real estate purposes was that it is "particularly important at the present time because of the shortage of private capital and mortgage money for individual homes, apartment houses, office buildings, factories and hotels."<sup>23</sup> Assuming the need for greater capital investment in real estate, the desirability of tax benefit legislation for this purpose must depend upon its effectiveness in accomplishing this end as against any undesirable ends that could result.

## II. ECONOMIC ASPECTS

The economic pros and cons that will result from this legislation are a matter of calculated speculation. Two primary assumptions can safely be made for this purpose. First, that the legislation will not increase the rate of savings. There is no reason to believe that the trust legislation will attract new investment capital that has not in the past been attracted to other available investment opportunities. Second, the amount of capital that will be transferred from other forms of investment into real estate depends largely upon the comparative return and risk between the trust and the other investment sources. The risk and return on investment in a trust depends, of course, upon the nature of the investment made by the trust within the limits set forth in the act.

### *A. Competition—Savings and Loan Associations*

A trust could invest its capital solely in mortgages.<sup>24</sup> This would be a comparatively safe form of investment, especially if the mortgages are insured. The trust will be in competition with savings and loan associations for savings to invest in mortgages. Similarly, the distributions to shareholders by mutual savings and loan associations are deductible from the taxable income of the association.<sup>25</sup> The savings and loan associations, however, offer three distinct advantages to investors not offered by real estate investment trusts: insured deposits; a liquid ownership interest represented by cash deposits which may be easily increased or decreased in whole or part; and the ability to charge "points"<sup>26</sup> for the granting of a loan which does not affect its tax status.

A real estate investment trust investing primarily in mortgages cannot expect to receive a greater return on mortgages than does a savings and loan association. The market value of the ownership

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23. *Ibid.*

24. Int. Rev. Code of 1954, § 856(c).

25. Int. Rev. Code of 1954, § 591.

26. "Points" are the charges made in addition to the interest charge. It is used on risk property or in a time of tight money as a charge for making the loan.



share in the trust should remain relatively constant, since there will be little speculation in the prospective earnings of the trust in relation to its capital assets. The purchasing and selling of the ownership certificate, in limited amounts, cannot be accomplished with the ease or simplicity of making and withdrawing deposits; and furthermore, a broker's commission may be charged. The trust is also at a disadvantage since it probably will not be able to use "points" as a means of collecting a higher interest charge in periods of tight money.<sup>27</sup>

On the basis of the above considerations, it is difficult to visualize a real estate investment trust specializing in mortgages having much impact on the present investment market. The amount of investment return offered by the realty trust investing in mortgages in excess of that offered by savings and loan associations probably will not be significant enough to induce investors desiring to invest in mortgages to pass up the advantage offered by mutual savings and loan associations. If this were not the case, the return might not be significant enough to attract investors from other areas into mortgage investment—certainly, not to the degree that is necessary to warrant a sizable tax revenue loss to the government.

#### *B. Qualification Requirements—Too Burdensome?*

The qualifying requirements for a real estate investment trust which invests solely in real estate equities, or in equities and mortgages, will hinder the trust's operation and investment appeal. The trust is restricted in the amount of active control to be exercised and in decisions to sell some or all of its real estate interests.<sup>28</sup> It is also limited by the distribution requirement as to the amount of "leverage" it can exercise.<sup>29</sup> Problems arise when a potential acquisition of property requires that the lease contain an overage provision based on net income;<sup>30</sup> if the trust is forced to operate a particular property;<sup>31</sup> or if the acquisition of a particular property requires that the trust take title to personal property along with the real estate.<sup>32</sup>

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27. "Points" or service charges for making a loan cannot be included as income for purpose of the income requirements. Proposed Treas. Reg. § 1.856-2(c) (2) (ii), 26 Fed. Reg. 605 (1961).

28. Int. Rev. Code of 1954, § 856.

29. The trust must distribute 90% of its taxable income in order to qualify for conduit treatment. Mortgage principal payments are not deductible. The principal payments on a large mortgage could prevent the trust from meeting the distribution requirement. Int. Rev. Code of 1954, § 857.

30. Rent as defined in this section excludes rent that is determined by the income or profits of the lessee from the property. Int. Rev. Code of 1954, § 856(d) (1).

31. Int. Rev. Code of 1954, § 856(d) (3).

32. Int. Rev. Code of 1954, §§ 856(c) (2), (3). The trust is disqualified if 10%

It is difficult to predict the return that a trust investing in real estate equities will offer, as this will vary with the amount of risk or speculation that a trust will undertake in light of the qualification requirements. However, the type of real estate that realty trusts will be inclined to invest in, is the prime or choice property. There has never been a shortage of investment capital for this type of property when all other areas of investment have not also felt a need for increased investment. The report of the House Committee on Ways and Means did not specifically state the types of real estate that need more investment capital, but used the broad categories of "individual homes, apartment houses, office buildings, factories and hotels."<sup>33</sup> The Committee must have been looking to the real estate in each of these classes that involves risk and speculation which make it less attractive to investors, particularly the institutional investors. Risk property is not a sound investment for realty trusts because of the limitations on management, income and sale.<sup>34</sup> The only relief that realty trusts will afford risk property is if their entry into the realty market indirectly causes other real estate investors to invest in more speculative property because of the added competition in the prime property market.

*C. Advantageous to those already in the real estate market*

The real potential of the real estate investment trust rests with the group of established real estate investors. The legislation provides an avenue for diversification for individual investment property owners. Now they may pool their properties and acquire wider realty interests without increasing their tax burden. Also, the existing real estate investment trusts which have previously been taxed as a corporation will undoubtedly attempt to qualify for the conduit tax treatment.<sup>35</sup> The advantage of the conduit tax would seem to offset any modification in operation that will be necessary in most cases,<sup>36</sup> unless the existing trust has a substantial depreciation shelter which offsets the corporate tax.

Real estate syndicates, organized as partnerships, comprise an-

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or more of its income is derived from, or 25% or more of its assets consist of, personal property.

33. H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960).

34. A realty trust will not want to get involved with speculative property since it cannot direct, manage or sell the property without being in danger of disqualifying itself for the conduit treatment. See Int. Rev. Code of 1954, § 856(c), (d).

35. See Ablon, Real Estate Investment Trusts and Alternative Forms of Investment, 7 Prac. Law 13-26 (1961).

36. Lease provisions, control and ownership of things other than real estate assets will have to be reviewed and modified according to each situation.

other potential class to be attracted to the realty trust. The syndicates are formed as limited partnerships, possessing many of the advantages of the corporate form, without the disadvantage of double taxation. However, the tax status of the syndicates has been continually in doubt, and intentional avoidance of the "association" classification has resulted in ambiguous restrictions on their activities.<sup>37</sup> Also, syndicates generally have lacked diversification, and the lack of a formal secondary market for investor liquidity has stifled their investment appeal. In the past few years, corporations, commonly called "syndicate successor corporations," have been formed by combinations of syndicates which have jointly incorporated to overcome prior individual shortcomings, notwithstanding the added expense of the corporate tax;<sup>38</sup> that is, if the corporate tax is not offset by depreciation deductions. The real estate investment trust provides syndicators with an alternative to the corporate form, permits increased diversification and the issuing of transferable ownership certificates readily marketable through a security exchange. The trust also allows the syndicate to depart from the questionable area of the "association" classification for tax purposes. The extent to which syndicates will elect to be taxed as real estate investment trusts depends largely upon the changes in current practice that will be required for qualification. There are undoubtedly syndicates that cannot qualify because of the type of property held; or because of an unwillingness to relinquish direct control over the property; or control in the management of the investment fund; or where the syndicate purposely holds property for short periods, taking a rapid depreciation and subsequent sale to realize a capital gain.<sup>39</sup> Nevertheless, the realty trust offers great possibilities for syndicates, and this potential will undoubtedly be tapped.

Corporations with substantial real estate holdings have also expressed an interest in realty trusts.<sup>40</sup> A corporation could transfer its real estate to a trust in exchange for ownership certificates which

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37. Int. Rev. Code of 1954, § 7701(a); Treas. Reg. § 301, 7701-2 (1960). See, Rustigan, *Effect of Regulation Definitions on Real Estate Syndicates*, 19 N.Y.U. 19th Inst. on Fed. Tax 1065 (1961).

38. Real estate investors can depreciate their property either by a straight line or an acceleration method. An able investor can offset the income on his property substantially by skillful trading and use of the correct depreciation scale.

39. Ablon, *supra* note 35 at 18.

40. Ernest Henderson, president of the Sheraton Hotels, announced shortly after the passage of the Realty Trust provision that his company had taken preliminary steps to convert the hotel chain into a real estate investment trust. The Hilton, Knott and Hotel Corporation of America chains have also expressed similar interests. N. Y. Times, Sept. 25, 1960, § 3, p. 1, col. 4, at 9, col. 2.

would then be passed on to the shareholders.<sup>41</sup> The trust would lease back the property to the corporation for continued use as before. Complications arise if ten per cent or more of the stock of the corporation is owned by the trust either directly or indirectly under the rules for attribution in Section 318 (a) of the Code.<sup>42</sup> In this event, the trust would not be qualified as the rent would not be includible under the ninety per cent income requirement. The other requirements could be more easily attained by the corporation in establishing the trust since no change in ownership interest of the shareholders is required.

The realty trust is of no value to corporations which have a tax shelter provided by the depreciation on their real estate. Where the property has been fully depreciated, however, a sale and leaseback to a realty trust established in conjunction with the corporation, permits a rental deduction by the corporation while enjoying continued use of the property. The rental charge could be based upon the past earnings and geared in such a manner that the distributions of the trust of this rental income would not exceed the normal dividend distributions of the corporation.<sup>43</sup> The rental income of the trust is then passed through the tax conduit shareholder-beneficiary. The corporation retains the same control over the property as lessee and its shareholders as beneficiaries of the trust.<sup>44</sup>

The capital gains provisions for the realty trusts is another reason for corporations to make use of the trust. The legislation provides for a special twenty-five per cent tax on the capital gains of the trust remaining after the distribution of capital gains dividends.<sup>45</sup> The capital gains dividend is taxed to the beneficiary as a long-term

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41. There is a question of whether this transfer would be tax free under § 351 of the Code. Proposed regulation § 1.856-1 (e) indicates that the provisions of subchapter C of the Code are applicable except where "inconsistent" with §§ 856-58. The extent to which § 351 might be inconsistent with §§ 856-58 is not clear.

42. The trust cannot own more than 10% of the total number of shares of all classes of the lessee. The attribution rules of § 318(a) are applicable with attribution running between a corporation and a 10% (rather than 50%) stockholder. Thus, any person who owns as much as 10% in value of the beneficial interests of the trust cannot own a 10% interest in the lessee entity. The property cannot be leased to any 10% shareholder individually, nor to any partnership or corporation in which a 10% shareholder has as much as a 10% interest. Int. Rev. Code of 1954, § 856(d) (2). Also, a lease back may be ruled out by the 25% asset test of § 856(c) (5) (B) since the trust is prohibited from owning more than 10% of the outstanding voting securities of any issuer.

43. The rent cannot be based on current earnings of the lessee. Int. Rev. Code of 1954, § 856(d) (1). However, a corporation that has owned the property over a period of time should be able to make a close estimate of the property's earning capacity or the corporation's profits. See also note 38 supra.

44. Nothing in the amendment prevents a trustee of the trust from serving as an officer of the corporation.

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

capital gain.<sup>46</sup> This income, if not for the trust legislation, would be taxable as normal income to the shareholder.<sup>47</sup> The advantages of this provision for investors in a high tax bracket provides a strong inducement for realty trust investment operating in conjunction with the corporations.

#### CONCLUSION

The use of realty trusts by existing corporations to avoid taxation does not come within the stated purposes for the realty trust legislation.<sup>48</sup> Nor does the adoption of the realty trust by syndicates, trusts or investors who hold property individually, fulfill the purpose of attracting more investment capital for real estate, absent a public sale of securities.<sup>49</sup> However, the greatest potential use of realty trusts lies with these groups that have established realty interests. Admittedly, the formulation of new organizations as realty trusts and the public sale of securities by existing organizations that elect to be treated as realty trusts will provide increased investment equality and attract investment capital into real estate. But the capital that is attracted by this means will not be in the quantity nor invested in areas that will result in a noticeable change in current real estate conditions.

The tax benefits afforded by the realty trust legislation carry a corresponding loss of tax revenue to the government. If hotel chains, railroads and other corporations with substantial realty holdings elect to be treated in part as real estate investment trusts as indicated, the tax loss will exceed the Treasury's conservative estimate of seven million dollars. Tax reductions in a period of mounting government expenditures should be limited to areas where a substantial constructive end is achieved. The realty trust legislation does not meet this requirement but only eliminates a minor tax inequity and affords limited relief at most to the shortage of investment capital for real estate. Tax revenue certainly seems more important than these accomplishments.

The realty trust legislation opens up a tax loophole that corporations can use for substantial tax savings. The current administration's position regarding preferential tax treatment was succinctly

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46. Int. Rev. Code of 1954, § 857(b)(3)(C). A capital gain dividend is any dividend designated as capital gain by the trust and which consists of the excess of the net long-term capital gain over the net short-term capital loss of the trust during the taxable year.

47. A capital gain realized by a corporation cannot be passed on to the stockholder as a capital gain.

48. See text accompanying notes 16 and 17 *supra*.

49. *Ibid*.

stated by President Kennedy in a special message on taxes to Congress:

[S]pecial provisions have developed into an increasing source of preferential treatment to various groups. Whenever one taxpayer is permitted to pay less, someone else must be asked to pay more. The uniform distribution of the tax burden is thereby disturbed and higher rates are made necessary by the narrowing of the tax base. Of course, some departures from uniformity are needed to promote desirable social or economic objectives of overriding importance which can be achieved most effectively through the tax mechanism. But many of the preferences which have developed do not meet such a test and need to be re-evaluated in our tax reform program.<sup>50</sup>

If the reasons given by the House Committee on Ways and Means are accepted at face value as the real intention for the passing of the realty trust legislation, a tax windfall to active business corporations was not intended. This potential tax benefit to corporations makes the limited relief afforded by the legislation even more costly and increases the list of tax loopholes that the current administration hopes to eliminate.

Perhaps it is impossible to limit tax legislation so that only the interests intended to be served are served. But if this is impossible, would not the status quo be preferable to the unmerited tax benefits that result from piecemeal additions to the Internal Revenue Code such as the realty trust amendment?

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50. Special Message on Taxes Submitted by President John F. Kennedy to Congress, N.Y. Times, Apr. 21, 1961, p. 18.