12-1-1962

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REAL ESTATE INVESTMENT TRUSTS: AN OLD BUSINESS FORM REVITALIZED

WILLIAM B. DOCKSER

On September 10, 1960, sections 856, 857 and 858 were added to the Internal Revenue Code of 1954, effective with the taxable year beginning in 1961. These sections established a new federal tax entity called Real Estate Investment Trusts. Since the passage of Public Law 86-779, there has been great interest in Real Estate Investment Trusts and a sizable number have been formed, but this number is small compared to the formation of Small Business Investment Companies following the Small Business Investment Act of 1958 and the development of Mutual Funds after the Investment Company Act of 1940. The relatively limited use of Real Estate Investment Trusts is due to a number of factors which will be explored and discussed in this paper. In recent months REITs have achieved widespread acceptance and are now appearing in the investment market with great regularity. This

* Member of the Massachusetts Bar; A.B., Harvard, 1959; LL.B., Yale, 1962. I am indebted to Professor Guido Calabresi of Yale Law School, who constantly assisted me in finding the errors of my logic. What remains is my own inadequate offering to legal scholarship. I would also like to acknowledge an unmeasurable debt to my wife, Carole Ann Dockser, who not only proofread countless drafts, but who also forsook normal living so that I could complete this paper.


2. As of July 1962, fifty-seven Real Estate Investment Trusts (hereafter, REITs) were formed following the passage of the Real Estate Investment Trust Act of 1960. All of these REITs are listed in a later section of this paper.


4. 54 Stat. 789, 15 U.S.C. § 80a (1958). The New York Times throughout the month of July 1962 listed almost 200 “mutual funds” in its Financial Section and gave their daily bid and ask quotations. To the best of my knowledge, the New York Times lists only one REIT and that is one that has been traded on the American Stock Exchange for a number of years.
paper attempts to explain the REIT as a tax entity and as a form of real estate investment.

The business trust is not well known or understood outside of a few sophisticated communities, in particular Boston and Chicago, and there are few attorneys and business people who have had experience with this form of investment. The business trust form has historically been used in a limited number of states, particularly through the East and a few central states; its use is even forbidden in some states.

A discussion of the business trust as it has developed is fundamental to an understanding of what Congress intended when it passed the Real Estate Investment Trust Act, since this was the form that was intended to be used under the Act. A discussion of the tax aspects of REITs will follow; then a discussion of the present and future activities of REITs and their relation to the real estate and investment fields in general.

I. REAL ESTATE INVESTMENT TRUSTS AS AN ENTITY

A. The Business or Massachusetts Trust

A business trust has been defined by the United States Supreme Court as,

a "form of business organization, common in that State [Massachusetts], consisting essentially of an arrangement whereby property is conveyed to trustees, in accordance with the terms of an instrument of trust, to be held and managed for the benefit of such persons as may from time to time be the holders of transferable certificates issued by the trustees showing the shares into which the beneficial interest in property is divided.

The business trust, as we now know it, had its origins in the middle eighteen hundreds, when Massachusetts law made it difficult to secure a charter for the development of real estate without an act of the legislature (General Court). Corporations were not allowed to own real

5. Chicago lawyers have had a great many dealings with the so called "Illinois Land Trust" over the years, which is a very common form of land ownership in Chicago, particularly of slum property. Boston lawyers originated the business trust and are well versed in its structure, problems and uses. Business trusts have been and remain a common form of real estate ownership in Massachusetts.

6. Hecht v. Malley, 265 U.S. 144, 146 (1924). See Annot., 156 A.L.R. 27, n.3 (1924) for a discussion of definitions of business trusts. In a note in 37 YALE L.J. 1103, 1105 (1928) the "Massachusetts trust" is defined in a similar manner as the Hecht case definition. "The term 'Massachusetts trust,' otherwise known as the 'business' or 'common law' trust is used generally to denote an unincorporated organization created for profit under a written instrument or declaration of trust, the management to be conducted by compensated trustees for the benefit of persons whose legal interests are represented by transferable certificates of participation or shares."

7. "It has been said that this method of conducting a commercial enterprise originated in this Commonwealth as a result of the inability to secure charters for acquiring and
estate as an investment. This meant that there could be no real estate corporations as such; thus the trust form had to be used. As early as 1854, a Massachusetts case noted the existence of the trust form for the purchase of real estate. This type of organization was used extensively for the development of Greater Boston real estate, and its use was copied in other fields outside of real estate. The business trust was given an amazing variety of uses until it came into general disfavor. There were numerous advantages to the trust form, and as corporations became more regulated and taxed, it appeared that the trust form might overtake and replace the corporate form, but this trend was reversed by subsequent events.

It was apparent that business trusts actively engaged in business were reaping a large tax advantage over corporations engaged in the same type of activities. In 1935, the Supreme Court resolved this problem in *Morrissey v. Commissioner.* Justice Hughes wrote that if (1) there are two or more individuals in a joint enterprise, and (2) it resembles a corporation, and (3) the purpose of this enterprise is carrying on business for profit, then this organization is an association taxable as a corporation. From this point on there has been little active move-

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8. In Attorney Gen. v. Federal St. Meetinghouse, 46 Mass. (3 Gray) 1 (1854) the court referred to companies "formed without incorporation, consisting of numerous numbers for the purchase of wild lands, with a view to a resale or other like purposes," where "the grant is made to trustees in trust for several members designated, and a certificate of such right to an aliquot part of the beneficial interest is usually issued by the trustees to several parties, indicating what aliquot part each holds in such trust property or beneficial interest . . . ."

9. The Boston Real Estate Trust was formed in 1886 with a capital of $2,000,000. This is the predecessor of the Real Estate Investment Trust of America. See Gardiner, *Real Estate Investment Trusts,* 100 TRUSTS & ESTATES 614 (1961) for a discussion of the origins of real estate trusts and its effect upon present REITs.

10. These trusts were largely responsible for the development of a number of middle and far west cities, namely Detroit, Chicago, Minneapolis, St. Paul, Kansas City, Omaha, Duluth and Seattle. See Kilpatrick, *Taxation of Real Estate Investment Trusts and Their Shareholders,* 39 TAXES 1042 (1961).

11. For discussions of the almost unbelievable uses of business trusts see 37 YALE L.J. 1103, 1106 (1928); 16 ILL. L. REV. 370 (1921); 15 LAW. & BANK. 205 (1885); Annots., 156 A.L.R. 29 and 156 A.L.R. 80, 81 (1942).

12. Besides the obvious federal tax advantages for which trusts were initially used so extensively, there were other advantages. Among these are comparative freedom from state regulation, avoidance of state corporate taxes, freedom of members from personal liability, continuation of the trust after members die, members avoiding association with the property through the intervention of the trustees holding title and the ready transferability of shares. There are advantages to the business trust when compared to either the corporate or the partnership forms of doing business.

13. Durrett, supra note 1, at 142, 143.


15. Durrett, supra note 1, at 143; Kilpatrick, supra note 10, at 1044.
ment to use the trust form rather than the corporate business form, except in the few instances where there is a particular business reason for so doing.

A body of law has developed on many phases of the law of business trusts, particularly in Massachusetts and Illinois. It is generally held that, in the absence of a statute, a business trust need have no limit on the duration of its existence. The Rule Against Perpetuities is not violated by a business trust, since these rules are directed against remoteness of vesting and with the business trust all interests are vested immediately in the holders of the transferable certificates of interest. It is also generally held that both the beneficiaries and the trustees can limit their respective liabilities and force creditors to look solely to the property of the trust for the settlement of their claims. By the very nature of the trust arrangement, the shareholder-beneficiaries have only limited control over the trustees; usually these powers include election and removal of the trustees within the terms of the trust instrument itself and the power, as defined by the trust instrument, to amend or terminate the trust. Care must be taken to keep the shareholder-beneficiaries' powers limited so that the trust cannot be viewed as a partnership and lose its limited liability. Compensation, duties, powers and restrictions of the trustees are generally governed by the trust instrument, but since the trust is a creature of equity, a reasonableness doctrine generally applies. The trustee of the business trust occupies a fiduciary

16. Liquid Carbonic Co. v. Sullivan, 103 Okla. 78, 229 Pac. 561 (1924) (definite period, or twenty-one years, or life or lives of beneficiaries); Hart v. Seymour, 147 Ill. 598, 35 N.E. 246 (1893) (no limit); Howe v. Morse, 174 Mass. 491, 55 N.E. 213 (1899) (life or lives in being plus twenty-one years); Hodgkiss v. Northland Petroleum Consol., 104 Mont. 328, 67 P.2d 811 (1937) (lives of trustees plus twenty-one years); Baker v. Stern, 194 Wis. 233, 216 N.W. 147, 58 A.L.R. 462 (1927) (no limit).
19. See discussion at 156 A.L.R. 85, 93, 105 (1945).
21. Goldwater v. Oltman, 210 Cal. 408, 292 Pac. 624 (1930); Whitman v. Porter, 107 Mass. 522 (1871); Liquid Carbonic Co. v. Sullivan, 103 Okla. 78, 229 Pac. 561 (1924); Feldman v. American Dist. Telegraph Co., 257 S.W. 929 (Tex. Civ. App. 1924). This problem is discussed further under the "State Law" section of this paper. See also 37 YAZZI, L.J. 1103, 1112 (1928). This problem of a trust becoming a partnership by the exercise of too much power in the shareholders is a subject that requires lawyers in each state to carefully consider their particular state law.
22. Courts of equity have long overseen the activity of trusts, and trustees are always responsible to the court for their conduct. See Mitchell v. Ormond, 282 Mass. 107, 184
relationship to the shareholder-beneficiary and the trustee must use the measure of care and diligence that would be exercised by a man of ordinary prudence and skill in the management of his own estate. The trustee is not an insurer, but generally is personally liable for malfeasance, gross negligence, fraud or wanton misconduct. He is relieved from personal liability if there is a clause in the trust instrument, effective under the appropriate state law, so relieving him.

B. State Law

In order to have a valid business trust, the trust must have an independent existence and be recognized by state law. A few states have prohibitions on the creation of express trusts for specified purposes, included in these are real estate investment trusts. These states include Montana, North Dakota, and South Dakota. Several states have in recent years amended their statutes so that real estate investment trusts would qualify under them. Among these are California, Michigan, Minnesota, Washington, Wisconsin and New York. Other states, such as Florida, allow for business trusts but the statutes are sparse and the case decisions do not disclose a great deal as to what activities

N.E. 471 (1933); Woodke v. Procknow, 238 Wis. 422, 300 N.W. 173 (1941). In Walker v. Close, 98 Fla. 1103, 1112, 125 So. 521, 525 (1929), rehearing denied, 98 Fla. 1125, 126 So. 289 (1930), the court said: "A reasonable compensation should be allowed to trustees for their services, care and responsibility incident to their position." Compensation of the trustees on the basis of a percentage of the profits of the trust (which is the typical REIT arrangement) was allowed in Dunbar v. Redfield, 7 Cal. 2d 515, 61 P.2d 744 (1936); Beltz v. Griggs, 137 Kan. 429, 20 P.2d 510 (1933).


In most states a provision relieving the trustee from personal liability in the trust instrument is not against public policy, but there are cases to the contrary, particularly in reference to tort liability. See Sleeper v. Park, 232 Mass. 292, 122 N.E. 315 (1919); Fisheries Co. v. McCoy, 202 S.W. 343 (Tex. Civ. App. 1918).


27. N.D. CENT. CODE § 59-03-02 (1960).


29. CAL. CIV. CODE § 2220 (1937).


33. WIS. STAT. ANN. § 231.01 (1957).

34. N.Y. REAL PROP. LAW § 96(7). See also N.Y. REAL PROP. LAW § 42(d); N.Y. PERS. PROP. LAW § 11(c).

35. FLA. STAT. ANN. § 609 (1956).

36. The early cases of Willey v. W. J. Hoggson Corp., 90 Fla. 343, 106 So. 408 (1925).
are allowable and what are not. There remains a large number of states in which the validity of a business trust for real estate investment is either in doubt or the courts appear hostile to them. Of course, there are also a number of states which have long recognized the validity of the business trust for real estate and have laws to regulate the business trust as an entity. Among these are Illinois, Massachusetts and Oklahoma.

As of March 27, 1962, thirty-nine REITs had filed with the Securities and Exchange Commission. These trusts were created under the following state laws: California, Colorado, District of Columbia, Florida, Georgia, Illinois, Maryland, Massachusetts, Nebraska, New York, Ohio, Pennsylvania and Texas. The status of the state law on the creation of business trusts is by no means clear in all of these states. Some states are enacting legislation to allow REITs to be formed under state law, whereas before the legislation the REIT would have been unable to exist independently. As of August 28, 1961, a new law became effective in Texas when that state's legislature passed the "Texas Real Estate Investment Trust Act."

As of July, 1962 there were 67 REITs throughout the United States. These trusts are concentrated in a few states; over three-fourths of them are located in nine jurisdictions. By far the greater number of these trusts were formed in the following states: Massachusetts (15), District of Columbia (7), New York (6), California (5), Colorado (5) and Pennsylvania (5). Several trusts have avoided registration with the SEC by limiting their offering to one state. This has been done by fairly small trusts in California, Georgia, Iowa, Louisiana, Nebraska, and Drew v. Hobbs, 104 Fla. 427, 140 So. 211 (1932), seems to be confused in holding the trustees liable under declarations of trust. Walker v. Close, 98 Fla. 1103, 125 So. 521 (1929), recognized the business trust in Florida. In Silliman, Partnership—The Uniform Act and the Florida Law, 5 U. Fla. L. Rev. 281, 290 (1952), it is stated that "Florida, after an apparently false start . . . finally saw the light . . . recognized a business trust for what it is."


41. Newsletter to members of the National Association of Real Estate Investment Funds (NAREIF) compiled by Robert M. Burr, Executive Director, and dated April 15, 1962.
Oklahoma and Wisconsin. The Appendix lists the 67 REITs, the place of their formation and their identifying characteristic. Of course, the state of formation of a REIT does not necessarily indicate nor limit the REIT’s principal place of business. Many of the trusts hold properties or mortgages in many states. The large number of REITs that were formed under Massachusetts law indicates a preference for the established doctrines and rules of Massachusetts’ business trust law rather than any particular desire on the part of these REITs to do business in Massachusetts. For some REITs the only contact with Massachusetts (state of formation of the trust) is a mailing address at a Boston law firm. This has been done even where the state in which that particular REIT planned to do its principal business allowed REITs to be formed.

There is at present one area of business trust law that is openly in conflict. It is the state “Blue Sky” laws and the state business trust laws. The various state security commissions are fearful that unless the investors maintain considerable control over the trustees, the trustees will become a self-perpetuating management group. In contrast to this policy are the common law and statutes of many states which say that the shareholder is liable as a partner for the debts and obligations of the trust if the shareholder-beneficiary exercises substantial control over the trustees. The regulations under sections 856, 857 and 858 are silent, except for allowing elections of trustees and terminating the trust, as to what control shareholders will have, or should have, over the trustees. The Midwest Securities Commissioners’ Association in March 1961 (Midwest Rules) and the California Commissioner of Corporations in May 1961 adopted requirements concerning real estate investment trusts to be regulated by them, which give the investor-shareholder the power to elect and remove the trustee, amend the trust.

43. The only recent attempt to list and categorize REITs is to be found in the February 12, and February 19, 1962, issues of Barron’s National Business and Financial Weekly in an article by J. Richard Elliot, Jr., entitled, More Room at the Top? (The author is unaware of the exact number of REITs being formed and the number changes rapidly.)
44. Several mortgage trusts doing their principal business in Florida have formed their trusts in Massachusetts. This is also true of trusts doing business exclusively in New York. Some of the newly created trusts in New York, despite the new law in New York allowing REITs to be formed, continue to create their trusts under Massachusetts law.
46. Wheat & Armstrong, supra note 45, at 926. See also Weissman, supra note 38a, at 747.
48. The Midwest Securities Commissioners’ Association is composed of the Securities Commissioners of Arizona, California, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, New Mexico, North Dakota, Oklahoma, Tennessee, Texas and Wisconsin. The statements of the Association are not binding on any state unless expressly adopted by that state, but the Association’s statements are often adopted by the member states, thus they are important to note.
indenture and terminate the trust. In October 1961 these shareholder powers were relaxed somewhat, but under some state laws these requirements may endanger the legal existence of the trust and turn it into a partnership. A partnership cannot qualify under the Real Estate Investment Trust Act. The Treasury Department appears to maintain that the control required by the "Midwest Rules" is not too much control for the purposes of sections 856-858 of the Internal Revenue Code and no disqualification will result from this particular part of the "Midwest Rules." Of course, individual states may find themselves in contradictory positions unless the business trust laws are made to conform to the apparent liberality of the federal act. One writer maintains that the power to select or remove the trustees would subject the beneficiaries to general liability under the laws of jurisdictions that have adopted the Uniform Limited Partnership Act.

C. Congressional and Lobbyist Intent

What did Congress intend when it passed the Real Estate Investment Trust Act? The Committee Report opens with the statement, "H.R. 12559 (Public Law 86-779) provides substantially the same tax treatment for real estate investment trusts as present law provides for regulated investment companies." Congress, apparently, wanted to create "mutual funds" for real estate. All of section II, entitled "Reasons For The Bill," is put in terms of equating real estate investment trusts and mutual funds (regulated investment companies) from the investors' point of view. The two principal reasons given for the bill are (1) to open real estate investments to small investors, and (2) to provide private

49. The "Midwest Rules" are discussed by Robert M. Burr, Executive Director of NAREIF, in Real Estate Investment Funds, Vol. 3, No. 9 National Real Estate Investor (Sept. 1961).

50. The Newsletter attached to Vol. 4, No. 1 National Real Estate Investor (Jan. 1962) notes the changes. See also 50 Ill. B.J. 570, 584 (1962) for a discussion of the changes.

51. "It is plain that even states which otherwise recognize business trusts and afford them limited liability will impose personal liability on shareholders and treat the enterprise as a partnership in additional respects if too much power resides in the shareholders." Committee on Partnerships & Unincorporated Business Ass'ns, supra note 45 at 907.

52. Sections 856-858 of Int. Rev. Code of 1954 are explicitly applicable only to trusts that meet the basic requirements of Section 856.

53. "Some doubt as to the effect of the requirements regarding shareholders' rights as to removal of the trustees, amendments to the declaration of trust and termination of the trust have arisen by reason of the language of the Proposed Treasury Regulations on REITs; however, the Treasury Department has advised that such limited controls do not conflict with the Proposed Treasury Regulations." Wheat & Armstrong, supra note 45, at 926.


capital for the real estate market. The Committee is careful to point out that "passive investments" are what are being encouraged, and "the active operation of business" is not meant to come within the tax advantages of the Act.57

Aside from the specific income and investment policies discussed later in this paper, the Committee is careful to use as its model of an acceptable real estate investment trust, the Massachusetts or business trust as it had come to be used. The Committee states that, "the general requirements include provisions that the trusts be managed by trustees, have transferable shares or certificates of beneficial interest, and that they be a type of organization which would be taxed as an ordinary domestic corporation in the absence of the provisions of this bill."58 It is clear from this statement that the Committee had the Massachusetts or business trust in mind when passing the Act.59 Congress intended that the real estate investment trusts be "publicly held" and every safeguard from an absolute minimum number to percentage interests was employed by the Committee to insure that there would be no abuse of the tax advantages by groups or persons that the Act was not meant to aid.60

The intention of the lobbying interests was very similar to that of Congress. Beginning about 1948, trustees of several Boston real estate trusts sought an amendment to the tax code so that their form of investment would be treated similarly to the mutual funds; they hoped that investor interest in real estate would be as meteoric as the rise in investor interest in "mutual funds."61 From the outset, these lobbying trustees were thinking in terms of "publicly held" trusts so that they were not opposed to a large minimum number of shareholders. At the same time, the lobbying trustees were hoping for a similar management-trustee relationship to that which exists between the mutual funds and the brokerage houses.62 The Act, on its face, was essentially what the Boston group had been seeking. The proposed regulations issued by the Treasury Department to interpret these sections of the

57. "In addition, your committee has also taken care to draw a sharp line between passive investments and active operation of business, and has extended the regulated investment company type of tax treatment only to income from the passive investments of real estate investments trusts." Id. at 44309.
58. Ibid.
59. See previous definition of the United States Supreme Court, quoted in Hecht v. Malley, 265 U.S. 144 (1924).
60. Congressman Keogh stated, "The bill has been carefully drawn to prevent its use by speculators or by those who might try to use it to get this 'pass-through' treatment for income from active business operations, as contrasted with passive investment income." 106 Cong. Rec. 15018 (1960).
61. Gardiner, Real Estate Investment Trusts, 100 Trusts & Estates 614 (1961) discusses the intentions and purposes of the "Boston Trustees."
62. Although this will be discussed later in this paper, I would like to point out now that it was natural for the trustees to expect that their relationship in REITs would be similar to those of trustees in regulated investment trusts.
Internal Revenue Code, and then in April, 1962 the final regulations, were for the most part a disappointment to the lobbying trustees. 63

II. TAX ASPECTS OF SECTIONS 856-858

In order to understand the problem in Real Estate Investment Trusts, we must pause and look at the federal tax aspects and requirements for REITs.

As to tax advantages, the REIT does not pay an income tax on dividends distributed to its beneficiaries, provided that it distributes at least 90% of its ordinary taxable income. 63a Any amount in excess of the 90% which is retained by the trust is subject to standard corporate income tax. 63b The REIT income is thus passed on to the beneficiaries without the necessity of paying a corporate income tax. The distributions are ordinary income to the beneficiaries. Capital gains of the trust, if distributed, are taxed at the beneficiary level as long term capital gains. 63c In this manner, the vast majority of REIT income is taxed only once, at the beneficiary level, rather than twice as is the case with corporations. However, REIT dividends are not eligible for the usual dividend deduction at the taxpayer level. 63d

On the organization level a REIT must be an:

1. Unincorporated trust or association; and
2. Managed by one or more trustees; and have
3. Beneficial ownership evidenced by shares or certificates of beneficial interest which are transferable; and
4. Shares held by 100 or more persons; and it must not be
5. A personal holding company; and
6. Holding property primarily for the sale to customers. 64

There are several asset and income requirements that a REIT must meet, and it might be helpful to compare these requirements with those of regulated investment companies. The gross income requirement of regulated investment companies is basically simple; at least 90% of gross income must be interest, dividends and gains; gains from securities held less than three months must be less than 30% of gross income. 65

The gross income requirements of REIT's breakdown into three categories:

63. See the N.Y. Times, April 30, 1962, p. 40, col. 3, for the statement of Joseph W. Lund, President of NAREIF.
63b. INT. REV. CODE OF 1954, § 857(b)(1).
63d. INT. REV. CODE OF 1954, § 857(c).
64. INT. REV. CODE OF 1954, § 856(a).
1. At least 75% of the trust gross income must be derived from:
   a. rents from real property;
   b. interest on obligations secured by mortgages on real property, or on land contracts, or on other interests in real property;
   c. gains from sale or disposition of real property including land contracts, other interests and mortgages;
   d. dividends or other distributions on gain from sale or other disposition of shares or beneficial interests in other real estate investment trusts which meet the requirements of sections 856-858; and
   e. abatements and refunds of real property taxes.66

2. At least another 15% of gross income of the trust must be derived from real property (real estate assets) or from sources from which a regulated investment company would be required to derive 90% of its income.67 This allows the REIT to have 15% of its gross income from dividends, interest or gains from the sale of securities, or if it chooses from real estate assets that were listed above. These two income tests allow the REIT to have 10% of its income from non-qualifying sources, thus giving a safety margin.

3. Less than 30% of gross income may be gains on securities held less than six months and gains on real property held less than four years, unless compulsorily or involuntarily converted.68

It is sufficient to say that these three gross income tests guarantee that the REIT will be investing in real estate or real estate interests and will enter into very few short term transactions. The income tests ("75%," "15%," and "30%") go hand in hand with the asset limitations to achieve what Congress intended when it passed the Real Estate Investment Trust Act.69

Regulated investment companies have rather complex asset requirements designed to insure diversification and prevent control of any one corporation by the "mutual fund."70 The asset requirements of REITs are simpler in one respect and more complex in another. The two asset tests for REIT's are:

1. At the close of each quarter of the taxable year of the trust at least 75% of the value of the total assets must be represented by "real estate assets";71 and

2. Not more than 25% of the value of the trust's assets can be represented by securities (other than those mentioned in (1) above),

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66. INT. REV. CODE OF 1954, § 856(c)(3).
67. INT. REV. CODE OF 1954, § 856(c)(2).
68. INT. REV. CODE OF 1954, § 856(c)(4).
69. See 4 CCH 1962 STAND. FED. TAX REP. ¶ 4099A, for the Ways and Means Committee explanation of the above sections of the INT. REV. CODE OF 1954.
70. INT. REV. CODE OF 1954, § 851(b).
71. INT. REV. CODE OF 1954, § 856(c)(5)(A).
and in meeting this 25% test only those securities can be included which do not represent more than 5% of the assets of the trust in any one security and not more than 10% of the outstanding voting securities of the issuer.\[VOL. XVII\]

The term “real estate assets” is defined as including fee ownership, co-ownership of land or improvements thereon, interests and mortgages on real property, shares in other qualifying real estate investment trusts, but not mineral, oil, or gas royalty interests.\[73\] The “75% test” also allows for the inclusion of cash, cash items, and government securities as allowable assets.\[74\] It is both apparent and justifiable that the regulations distinguish personal property which is leased together with real property as not qualifying for inclusion in the term “real estate assets,” which along with cash, cash items and government securities, make up the 75% test.\[75\] The regulations set out a list of examples of these non-qualifying items.\[76\]

The first test (75%) is perfectly reasonable and easy to understand, but the second test (25%) is both unnecessary and could prove to be most confusing since it takes the regulated investment company asset test and applies it out of context to REITs.\[77\] A thirty-day grace period is allowed in each quarter in order that the REIT may readjust its assets if it has failed to meet one of the above tests; if it fails to do so it is subject to the corporate income tax.\[78\]

Probably the single most complex and controversial aspect of the Real Estate Investment Trust Act is section 856(d) which defines “Rents from Real Property,” which is one item that goes into the “75%” and “15%” tests of gross income. The statute provides that “rents from real property include rents from interests in real property but does not include”: (1) rent dependent on income or profits;\[79\] (2) rents from “related” tenants;\[80\] and; (3) rent where the trust furnishes services or “manages” the property.\[81\] Presumably all other rents from interests in real property (as defined by local law) can be included in “rents from real property.” A detailed look at each of these exclusions is necessary since they are an area of present conflict and probably will be the basis of a great deal of future litigation.

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73. Int. Rev. Code of 1954, §§ 856(c)(6)(B) and 856(c)(6)(C).
(1) The first of the excluded types of rental income is designed to avoid any profit-sharing with the tenant. The statute states that "if the determination of such amount [rent] depends in whole or in part on the income or profits derived by any person from such property," excluding from this rents "based on . . . fixed . . . percentages of receipts or sales," the "rent" cannot be included in "rent from real property" for purposes of sections 856(c)(2) and 856(c)(3). The report of the Ways and Means Committee broadens the above limitation to the extent that it states it is immaterial if a lease is based upon a fixed percentage of sales or receipts whether or not these amounts are adjusted for federal, state and local sales taxes. The Committee intended to show that the purpose of this exclusion was to avoid profit-sharing, but not to prevent or exclude rents based upon reasonable contracts calling for a percentage of gross sales with allowances for returns and differences in products to be sold by the tenant.

Proposed Regulation 1.856-4(b)(1) contained two controversial statements. The proposed regulations stated that if the trust enters into a lease with a tenant that is not based solely upon a fixed sum, and the tenant in turn enters into a sublease "which provides for a rental based in whole or in part on the income or the profit of the sublessee, the entire amount of the rent received by the trust from the prime tenant with respect to such property is disqualified as 'rents from real property.'" This proposed regulation stretched the "indirectly" of section 856(d)(1) considerably beyond what is necessary to prevent profit sharing between the trust and the tenant. If the REIT entered into a perfectly allowable lease with a tenant, based upon a percentage of gross sales, and the tenant in turn sublets one department or store on a participation in profits basis, under the proposed regulations the entire rental income from this property would be excluded from the "75%" test. The final regulations have relaxed this overly stringent requirement by adding the following language: "[I]f, 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 or income or profit" the rent would be disqualified as "rent..."
While not clarifying the situation completely, the new regulations do make it clear that only “profit sharing” lease arrangements that are not generally used will be attacked under this section. It awaits further clarification by the Internal Revenue Service to see just what will be acceptable to them and what will be too much “profit sharing” through the subtenant.

The last sentence of Proposed Regulation 1.856-4(b)(1) disqualified rents merely by reason of the existence of a lease provision that provided for additional “overage rents” based upon a tenant’s net profit beyond a set amount. This section was questionable because it appeared to disqualify rent which was not dependent on “income or profits derived by any person” and the statute disqualified only such amounts as are “received or accrued,” while the proposed regulation attempted to disqualify such amounts merely on the basis of the existence of a lease provision which may or may not generate a receipt or accrual. The final regulations have done away with the problem in that the existence of an “overage rent” provision does not prima facie disqualify all rents under the lease from being included in “rents from real property.” If the “overage rent” provision does not generate any income the REIT will be able to include all of the rental under the lease as “rent from real property.” This will allow the REIT to enter into more flexible leases allowing for greater participation in the future growth of a particular property. If the subsequent growth is so dynamic the REIT may well be willing to give up the inclusion of this particular rental in “rent from real property” in order to receive the greater return, this participation in the growth of the property need not disqualify the REIT from the benefits of sections 856-858, because that would depend on the nature of the other investments and whether or not even with this particular non-qualifying rent the REIT would come within the provisions of the Act.

(2) The second type of excluded rental income is that which is received from a lessee in which the trust has a substantial interest. The test of a substantial interest is 10% whether a corporation (via stock) or a person not a corporation (via assets or net profit). This section is redundant and confusing to this writer in that if the trust

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86. See note 84 supra.
87. INT. REV. CODE OF 1954, § 856(d)(2).
89. “However, where the amount received or accrued for a taxable year under such an agreement includes only the fixed rental, the determination of which does not depend in whole or in part on the income or profits derived by the lessee, such amount may qualify as ‘rents from real property.’” Treas. Reg. § 1.856-4(b)(1) (1962). (Emphasis added.)
90. INT. REV. CODE OF 1954, § 856(c)(3).
owns 10% or more in the securities of a particular corporation, whether a tenant or not, the trust has not met the asset requirement of section 856(c)(5)(B) and would be disqualified from the benefits of the Real Estate Investment Trust Act.\(^9\) It seems of little use and consequence that the rental income from this "controlled" corporation or person would also not be considered as "rent from real property." This confusion resulted because income tests of regulated investment companies were arbitrarily applied to REITs.\(^9\)

(3) The third type of excluded rental income arises when the trustee performs too many services and ceases being passive,\(^9\) and when the independent contractor is not "independent" enough.\(^9\) The REIT is not allowed to supply services directly to the tenants, but the REIT must use the services of the independent contractor.\(^9\) If the trust fails to do this the rent is excluded from "rent from real property."\(^9\) Most commentators have criticized the proposed regulations under this section.\(^9\) These commentators argued that the proposed regulations are so restrictive that the REIT would have to enter into net leases with the independent contractor "or all employees in the building must be the employees of the independent contractor who manages or operates the property."\(^9\) The final regulations have made some important changes.\(^9\)

Under the proposed regulations, the independent contractor was not allowed to be a tenant of the REIT or more accurately, the rent from the independent contractor could not be included in "rent from real property."\(^9\) This seemed somewhat harsh to the extent that if the transaction is an "arm's length arrangement," this relationship is probably all that Congress meant to require. In most real estate

\(^9\)treas. Reg. § 1.856-2(d)(2) (1962) notes this problem, but does not try to resolve it.


\(^9\)vol. 3, no. 9 national real estate investor 29 (sept. 1961); carr, federal tax aspects of real estate investment trusts, 16 bus. law, 934, 938 (1961); kilpatrick, taxation of real estate investment trusts and their shareholders, 39 taxes 1042, 1050 (1961). wolder, real estate investment trusts, 39 taxes 664, 669 (1961) discusses what was expected before the proposed regulations were released.


\(^9\)101. Proposed treat. Reg. § 1.856-4(b)(3), 26 Fed. Reg. 607, 608 (1961). "Thus, for example, the trust may not receive any dividends or rent from the independent contractor."
management arrangements today, the independent contractor or manager does occupy space in the building under its supervision, and this has been considered a wise policy in that it insures more complete supervision. The absence of a reference to this situation in the final regulations leads this author to believe that this would now be allowable.

The single most criticized sentence in the proposed regulations was in Proposed Regulation 1.856-4(b)(3), which said, "In addition, maintenance and repairs of the trust property, the costs of which would be deductible under Section 162, must be controlled and paid for by an independent contractor." The proposed regulations allowed the trust to make capital expenditures, make leases and deal with taxes, insurance and interest, but the above quoted sentence apparently required the independent contractor to pay for repairs. One writer stated: "This provision appears to have no statutory basis, nor does there appear to be any policy reason for it." It would be unrealistic to require the burden of repairs to be borne by the contractor since this would inevitably lead to a conflict of interest between the parties. This problem was resolved by final Regulation 1.856-4(b)(3)(d), which clearly states that "the 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 with respect to the trust's property (as defined in Section 263) and may make decisions as to repairs of the trust's property (of the type which would be deductible under Section 162), the cost of which may be borne by the trust." (Emphasis supplied.) This regulation clarified what was becoming a serious problem to the REIT trustees and to the independent contractors who were managing the REIT property.

The independent contractor is carefully defined by the regulations to be a person or corporation who does not own 35% of the shares of the REIT or a person or corporation which is not "owned" (35%) directly or indirectly by persons who own 35% of the REIT. Section 318 applies to section 356 with the modification that 10% is substituted for 50% in terms of control to insure that the independent contractor be independent of the people who own the beneficial shares in the REIT. This means that individuals who own 35% of the shares of trust cannot each have a 10% interest in any corporation that has a 35% interest in the independent contractor.
It would seem appropriate at this point to discuss one other controversial aspect of the regulations; the next to the last sentence in Regulation 1.856(d)(1) states that: “a trustee of real estate investment trust may not be an officer or employee of, or have any direct or indirect proprietary interest in, any independent contractor which furnishes or renders services pertaining to the trust property, or manages or operates such property.” While this limitation on trustees may be desirable, it is neither required by the statute nor was it probably intended by Congress in passing the Real Estate Investment Trust Act. 110

It certainly was not expected by those seeking passage of the Act. 111 Congress had the general intention to create mutual funds for real estate, and no express provision exists in sections 856-858 which limits those connected with the independent contractor from being trustees of the REIT. It is doubtful that Congress meant that the trustees could not be connected with the independent contractor. Support for this view is found when one looks at the situation in regulated investment companies. 112 The general rule is for the mutual fund officers to be connected with the advisory corporation or the brokerage house that collects the buying and selling commissions or charges an advisory fee. 113 The definition of “independent contractor” does not preclude anyone from also being a trustee; this definition merely puts a limitation on the percentage interests that the REIT owners have in the independent contractor and a percentage limitation that the independent contractor can have in the REIT.

Both historically and practically, the trustees of “business trusts” dealing in real estate have usually been connected in some way with the management corporation or partnership. Generally this leads to intelligent management, and in the event that the trustee abused his dual position he would have violated his fiduciary duty and could be held liable and removed from office with the proper action. 114 Since the trustees can be removed by the shareholders, he could be removed by a simple vote without resorting to court action. 115 Of course, there are

110. The House Committee on Ways and Means stated: “The independence of the contractor is assured by providing that: The trust may not receive any income from the contractor; the contractor may not own more than 35 per cent interest in the trust; and not more than 35 per cent of the stock (or voting power) of a corporate contractor (or interest in the assets and profits if not a corporation) can be held by a person or persons holding a 35 per cent or greater interest in the trust.” 4 CCH 1962 STAND. FED. TAX REP. ¶ 4099A, at 44310.

111. Grant, Real Estate Investment Trusts, 100 TRUSTS & ESTATES 766 (1961); Vol. 3, No. 9 NATIONAL REAL ESTATE INVESTOR 29 (Sept. 1961); and Carr, supra note 99, at 935. See also Kilpatrick, supra note 99.


115. See earlier section of this paper under The Business or Massachusetts Business Trust.
good reasons why the number of trustees who can be affiliated with the
independent contractors should be limited.\textsuperscript{116} Section 10(a) of the
Investment Company Act of 1940 allows 60\% of the trustees of a mutual
fund to serve as officers or employees of an independent contractor.
This author would favor a limitation that 40\% of the trustees of a REIT
be allowed to be affiliated with the independent contractor, but it must
be pointed out that only Congress can set any limit, since it is not the
power of an administrative agency to amend a law of Congress.\textsuperscript{117} As
section 856 of the Internal Revenue Code now appears, the author sees
no justification for prohibiting a person affiliated with the independent
contractor from serving as a trustee; on the contrary, the history and
intent of Congress was to allow this type of activity and dual
relationship.\textsuperscript{118}

III. \textbf{Uses of Real Estate Investment Trusts}

In the brief history of REITs, there have developed six distinct
types of REITs that have been marketed to the public. These are
(1) "blankcheck" trusts; (2) exchange trusts; (3) purchasing trusts;
(4) mixed trusts; (5) existing trusts; and (6) mortgage trusts.\textsuperscript{119} These
six types of trusts exhibit the great ingenuity of the real estate com-
munity to develop variations of REITs.\textsuperscript{120}

A. "Blankcheck" Trusts

The "blankcheck" trusts are very simple to understand. The REIT
states in its prospectus that it will invest in real estate that meets
a number of highly desirable characteristics, but there is no mention of
specific properties, nor of any contract to buy any particular property.
This type of trust has been marketed to the public strictly on the reputa-
tions and names of the promoters and proposed trustees. These "blank-

\textsuperscript{116} There always remains a problem of obtaining information on the REIT's activi-
ties, and having some "independent" trustees to watch out for the shareholders' interest
would be beneficial. Also having a majority of "insider" trustees may be pushing human
weaknesses to limits that are not advisable. On the other hand, it would be beneficial to
the REIT to have some "insiders" as trustees.

\textsuperscript{117} This proposition is so well ingrained in American jurisprudence that it requires
no citation. See Western Union Telegraph Co. v. Lenroot, 323 U.S. 490 (1945); 1 MERTEN,
\textit{FEDERAL TAXATION} \S 3.21 (1962).

\textsuperscript{118} For a general discussion of the tax aspects of REITs see 33 \textit{ROCKY MT. L. REV.}
364 (1961); Carr, \textit{Federal Tax Aspects of Real Estate Investment Trusts}, 16 \textit{BUS. LAW.}
934 (1961); Kilpatrick, \textit{supra} note 114. For a pessimistic view of REITs see 1961 \textit{WASH.
U.L.Q.} 436.

\textsuperscript{119} For a general discussion of the uses of REITs see Barron's National Business
and Financial Weekly, February 12 and 19, 1962. See also Sandison, \textit{REITs Spark Interest
of Tax Wise Investors in Real Estate Market}, 16 \textit{J. TAXATION} 242, 244 (1962).

\textsuperscript{120} For obvious reasons, I do not discuss the relative merits or disadvantages of
particular REITs. I have attempted to generalize my discussion so that the REITs could
be placed in categories, and in each category I have named one or two trusts in existence
of each type. My selection of REITs as examples is for demonstration purposes, and it is
in no way to be construed as a preference of any particular REIT.
check" trusts are usually led by men of great integrity in the community who for a number of reasons do not want the REIT committed to any specific real estate at its formation. Thus far, this has been the most common form of REIT marketed to the public.\textsuperscript{121}

One of the first and largest REITs to get clearance from the Securities Exchange Commission was the Greenfield Real Estate Investment Trust, which bears the name of Albert M. Greenfield, a highly respected real estate operator in Philadelphia. In March of 1961 the Greenfield Real Estate Investment Trust offered, through Drexel and Company, 500,000 shares at $20 a share, and the issue was oversubscribed in a brief period. As of May 31, 1962, the Greenfield Real Estate Investment Trust was being traded over the counter at a range of \(13\frac{3}{4}\) bid--\(14\frac{1}{2}\) asked.\textsuperscript{122} The reason for this sharp decline in price is that the Greenfield REIT trustees have only invested in one parcel of real estate as yet. The money that was raised in the sale of shares, about $9,500,000, is all in treasury bills and cash,\textsuperscript{123} except for the single investment which involved a cash outlay of approximately $350,000.\textsuperscript{124} It is not any easy matter to invest many millions of dollars in real estate that is meant to have a long term investment future. Proper selection and investigation takes time, but in the meantime, thousands of investors are getting little return on their money and contrary to what they hoped, they have only a minor interest in any real estate.

The preceding case study points out the basic weakness in "blankcheck" trusts. These REITs may be a good investment (or a poor one) in the long run, but at least for a number of years the investors will be disillusioned about what they bought. Since with a "blankcheck" trust there is little to disclose, the SEC disclosure requirements are of little value to potential investors.\textsuperscript{125} The prospectuses of these trusts are so general that a careful reading discloses that the trustees can invest in almost anything, or not invest at all. When one invests in a "blankcheck" trust, he is investing in the names and potential talents of the trustees.\textsuperscript{126} The limitations that appear in these "blankcheck" REITs

\begin{footnotesize}
\begin{enumerate}
\item Thirty-three out of 67 known REITs are of the "blankcheck" type. The figure of 67 REITs includes 10 existing trusts, so that we can see that the percentage of "blankcheck" REITs that have been recently formed is very high, representing 58\% of all the new trusts.
\item Vol. 4, No. 6 NATIONAL REAL ESTATE INVESTOR 13 (June 1962).
\item Greenfield Real Estate Investment Trust acquired a shopping center in Drexel Hill, Pennsylvania. This transaction is noted in Vol. 4, No. 4 NATIONAL REAL ESTATE INVESTOR 12 (April 1962).
\item It is suggested that the reader obtain a copy of the prospectus of any "blankcheck" trust and read it for a study in saying nothing in 30 to 40 pages. The SEC does not allow optimistic statements of intention, so that the counsel for the "blankcheck" REITs have been careful to allow any type of investment or action that the Real Estate Investment Trust Act would allow.
\item A number of writers maintain that this is "the way" to invest in a REIT. See Swesnik, Realty Investment Trusts and the Potential Investors, The Commercial and
\end{enumerate}
\end{footnotesize}
are those usually imposed by statute or "blue sky" laws. Of course, the failure of the Treasury to issue promptly final regulations of sections 856-858 was also a serious factor in the delay in investing by the "blank-check" trusts. It is likely that the "blankcheck" REITs will now move ahead with their investments much more rapidly than they have done in the past.

B. Exchange Trusts

Exchange trusts are trusts created by the exchange of beneficial-shares of the REIT for interests in existing real estate. If the event is a taxable event, the REIT would get a new basis for depreciation, but if section 351 applies, the REIT must accept the basis of the transferring parties. Of course, from the individual's point of view, section 351, allowing non-recognition of gain or swaps, is a most beneficial situation. This allows small or medium sized real estate holders to band together and come out with something quite different, and not realize any taxable gain in the occurrence.

This technique was used by the Liberty Real Estate Trust which registered $25,000,000 in shares with the SEC, and as of the first of the year had exchanged $6,162,522 in shares for assets worth $11,415,936 with an equity value after mortgages of $6,162,936. Its portfolio is extremely varied and includes office buildings, commercial and apartment buildings, motels, bowling alleys and mortgages. The individual investors gain a great deal from this exchange since they now have diversified investments and ready marketability for their shares.

Financial Chronicle, April 6, 1961, p. 11. See also Flexner, Future of Real Estate Investment Trusts Hinges on Able Management, 100 Trusts & Estates 542 (1961). For this same thesis directed at the investment public, see Real Estate Investment Trusts, Changing Times, Jan. 1962, pp. 27, 30.

127. Section 351(a) provides: "General Rule—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such persons or persons are in control (as defined in Section 368(c)) of the corporation. For purposes of this section, stock or securities issued for service shall not be considered as issued in return for property."

The purpose of section 351 is to allow a person or persons to transfer property to a corporation in exchange for stock without realizing a taxable gain or loss on the transfer. For example: If A transfers real property, which at the time of transfer has a value of $100,000, and a cost (computed after allowing for possible prior depreciation allowances) of $50,000 to A, A would not have to recognize the gain of $50,000 at the time of transfer, provided that A controlled the B corporation. To be in control of the corporation A must own, immediately after the transfer at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock. Treas. Reg. § 1.351-1 (1962). However, the basis of the stock in A's hands would be $50,000, so that A would realize only when he sells his stock in B corporation. If section 351 applies to transfers creating REITs, the REIT shareholders would not have to realize any gain on the transfer of real property to the REIT in exchange for the shares of the REIT, provided that the control requirement was met.
The popularity of this type of trust is assured, as long as the benefits of section 351 apply. The author has spoken to a number of real estate owners who have stated that if section 351 definitely applies and the final regulations were at all "reasonable," they will seek to form REITs. Interest in the "exchange trust" could prove to be far beyond expected if the Liberty Real Estate Trust is not challenged on the basis that section 351 does not apply to the formation of REITs. The Flato Realty Investments has registered shares for $20,000,000 for the purpose of creating an exchange trust by June of 1962.128

C. Purchasing Trusts

The purchasing trust is a REIT organized to purchase specific real estate, either one property or several. In filing with the SEC this form of REIT must disclose a great deal of information about the earning records, prospects, prices, arrangement, etc. that will reflect what the REIT is planning on buying.129 This could be termed a variation of syndication, but it need not be limited, as most syndications are, to a single property.130

One small REIT was formed to serve as an alternative to syndication. This was the Gateside-Architect Building Trust, which sold 139 shares at $5,000 each for the purpose of owning one building. This may be a complicated way to handle such a relatively small transaction, but it does offer the safety of the Real Estate Investment Trust Act and may offer a number of benefits in the long run.131

Another, and probably more appropriate, use of the purchasing trust is the U. S. Realty Investments, which described in detail its proposed acquisitions in its prospectus and has proceeded to buy them with the $6,661,975 raised from the public. U. S. Realty Investments purchased a number of properties and has recently filed a second registration for $6,000,000 to purchase more designated properties. Thus, from the investor's point of view, there are certain advantages: knowledge of what he is investing in, diversity and the benefits of the Real Estate Investment Trust Law. U. S. Realty Investments was selling on May 31, 1962, at a slight premium over the amount for which it was

128. The Flato Realty Trust prospectus, dated February 13, 1962, states that in the opinion of counsel, section 351 does apply to the formation of a REIT. It is the opinion of this writer that section 351 does apply to the formation of REITs, but I would not be prepared to so state in an "Opinion of Counsel" without a "Letter Ruling" from the Tax Ruling Division of the Internal Revenue Service.


130. The complexity of arranging a syndication for more than one property is what imposes a practical limitation on the use of the syndication method for multiproperty financing.

131. Congress is at present reviewing syndication operations and the founders of the Gateside-Architect Building Trust are believed to have weighed this factor in the selection of the trust method as opposed to a more usual syndication.
issued, as compared to the "blankcheck" trusts which are generally selling at a considerable discount.

D. Mixed Trusts

Mixed trusts are REITs that were organized with usually one specific land or real estate purchase in mind and then coupled with a "blankcheck" clause to cover the excess funds. This serves the purpose of informing the public as to one property the REIT is buying and implying that other properties will be of a similar nature. This is a better situation for the investor than the total "blankcheck" trust, where there is no way of knowing in what properties the REIT will eventually invest.

There are two conspicuous examples of this type of trust, the Washington (D.C.) Realty Investment Trust (600,000 shares at $5 per share) and the First National Real Estate Trust (2,500,000 shares at $10 per share). The Washington Realty Investment Trust stated in its prospectus that it intended to use one-third (about one million dollars) of the proceeds of the sale to acquire a specific apartment house. The remainder was to be later invested on a "blankcheck" basis. The First National Real Estate Trust disclosed in its prospectus that it would acquire a $1,700,000 apartment complex (mortgaged for $950,000) with part of its proceeds. Again, this gives the investor an opportunity to see the nature of the properties that will probably be invested in, while at the same time it allows the REIT a great deal of flexibility in its future investments.

E. Existing Trusts

Existing trusts are the trusts that have proven earning capacity and that were in existence before the passage of the Real Estate Investment Trust Act of 1960. This type of trust offers the investor established portfolios, established earning records, and probably conservative management.

Most conspicuous in this group is the Real Estate Investment Trust of America which traces its existence back to 1886. The Real Estate Investment Trust of America had over $22,000,000 worth of real estate on its books prior to its $10,000,000 public offering in June of 1961. These holdings are soundly diversified in thirteen states and represent enlightened conservative management.

Another large, established REIT is the Bradley Real Estate Trust which has announced that it will not offer any new shares to the public until after the final regulations of the Treasury have been examined. Even without new shares, the Bradley Real Estate Trust has over a million shares outstanding.132

F. Mortgage Trusts

Mortgage trusts are a considerably different type of investment than any of the five types listed above.\(^{133}\) The mortgage trusts are set up to hold mortgage interests, not equity interests. These trusts can vary from very safe low yield government insured mortgages to high yield speculative construction or second mortgages.\(^ {134}\)

One of the earliest REITs to register with the SEC was the First Mortgage Investors, which offered one million shares at $15 a share in September of 1961. The present price of the shares is considerably more than this initial price. First Mortgage Investors has announced a policy of dividing its mortgages between FHA-VA insured home loans and development and construction loans. The government insured mortgages will yield roughly 5\%, but this will be balanced with 10-12\% yields on development and construction loans which should give the trust an overall yield of 8-9\%.\(^ {135}\) The Continental Mortgage Investors issued 1,700,000 shares at $15 per share on March 22, 1962, and was immediately oversubscribed. Continental has announced a policy of dividing its portfolio between government insured mortgages and construction mortgages.\(^ {136}\)

The Mortgage trust will undoubtedly be the first type of REIT to attempt to issue senior securities so as to give the shareholders greater leverage. A great deal will depend upon the cost of money since the mortgage REIT will have a fairly fixed return, but assuming that the REIT earns 8\% and must pay 6\% for borrowed capital, this leverage could be used to make the mortgage REIT an attractive high yield investment. It is hoped that senior securities will be issued in ratios as high as five to one over equity capital, thus giving great leverage.\(^ {137}\)

The mortgage REITs also may be able to serve the purpose of "warehousing" the paper of the banking institutions. This could be a stabilizing factor in the conventional mortgage market, such as "Fanny May" is to the government insured market. The First Mortgage Investors hopes to become a "banking institution" on a nationwide scale and expects that through the use of senior securities it will have sixty million dollars available in the next two years for the purchase of mortgages.\(^ {138}\)

A mortgage trust could well be the first open ended REIT.\(^ {139}\) The

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\(^{134}\) For a general discussion of mortgage trusts see ibid.; Flexner, supra note 126; 22 MORTGAGE BANKER 30 (April 1962).

\(^{135}\) First Mortgage Investors early earning reports are noted in Vol. 4, No. 6 NATIONAL REAL ESTATE INVESTOR 12 (June 1962).

\(^{136}\) N.Y. Times, March 22, 1962, p. 49, col. 5.

\(^{137}\) Barron’s National Business and Financial Weekly, supra note 133; 22 MORTGAGE BANKER 30, 31 (April 1962).

\(^{138}\) Barron’s National Business and Financial Weekly, supra note 133.

\(^{139}\) Discussed in detail in the next section of this paper.
SEC has rejected all open ended REITs to date because of the myriad of evaluation problems, but these problems become minor when dealing in mortgages which do have a readily establishable value depending upon current mortgage yields on specific risks. The First Mortgage Investors is offering its shareholders a dividend reinvestment plan which means that the REIT will pay dividends to those who want them this way, in shares rather than cash. The value will be determined by the prevailing market price for mortgages and the Real Estate Investment Trust Act will be complied with. There is no reason why mortgage trusts may not in the near future become hundred million dollar trusts doing business on a nationwide scale. Yields could safely be as high as 16–18% on each equity dollar if senior securities are as widely used as is anticipated.

IV. THE INVESTOR AND THE REAL ESTATE INVESTMENT TRUST TRUSTEE

In the opening section of this paper there was a discussion on the business trust as a form of doing business. At this point, the author would like clearly to distinguish the business trust from the corporate form on the basis of one particular characteristic; namely, investor control of the management. In a corporation, the power to run the corporation rests in the hands of the board of directors, and the board of directors is elected by the stockholders. While the business trust appears to have a similar arrangement, there are several important differences.

The business trust is run by the trustees. The trustees may or may not have been elected by the beneficial certificate holders. Conceptually, a trust is operated for the benefit of the beneficiaries, but the beneficiaries need not have any mathematical majority control. Until the creation of REITs, there was little need to attempt to apply the so-called “corporate democracy” ideas to the business trust, because it was assumed that those who used the trust form for business knew what they were doing and did not need special protections.

To illustrate the above remarks, the author would like to point out that some of the REITs that have been established require an affirmative vote of two-thirds of the beneficial certificate holders to remove a trustee, otherwise the other trustees select who is to be a trustee. Even the Midwestern Security Commissioners have realized that a REIT is not to be treated like a corporation as far as voting powers are concerned; they

141. The theory of leverage can be used to show yields in any range from 10% to 50%, but I believe that the 16 to 18 per cent figure is reasonably attainable if senior securities are used in the mortgage REITs.
142. Historically the beneficiaries often needed 75% or 66% control (vote) to remove trustees. See Kilpatrick, supra note 114.
have amended their original position and now allow the trustees to be elected every three years instead of their original position of every year.\footnote{143} Of course, the "Midwest Rules" still require the affirmative election of trustees by a majority vote and the REITs used in the illustration above would still not qualify for the Midwestern "blue sky" laws.\footnote{144}

The exact rights and powers of shareholders in a business trust are a matter of state law and beyond the scope of inquiry of this paper, but it cannot be emphasized enough that a business trust is not a corporation, and although this will be said over and over again, investors buying on exchanges and over the counter will treat them the same in their minds, and, eventually, serious litigation will develop.\footnote{146}

V. Open Ended Real Estate Investment Trusts

In the discussion of mortgage trusts in the preceding sections, mention was made of "open ended" trusts. There is nothing in the Internal Revenue Code, sections 856-858, to prevent a REIT from being "open ended." Most "mutual funds" operate on an "open ended" principle, which means that at a fixed point in time, usually each day, the fund, an affiliate or a subsidiary stands ready to buy or sell shares of the fund at a price based upon an evaluation of the assets of the fund. Conceptually and legally, there is no reason why a REIT cannot undertake this sort of activity. Thus far, the SEC has refused to allow any REIT to set themselves up in this manner and, so that the public will not be deceived, the SEC has not allowed any REIT to use the word "fund" in its name.\footnote{146} The reason for this is a very practical one. The success of "mutual funds" is greatly attributable to this method in that it gives great marketability to the shares and allows for limitless growth.

The SEC is strongly opposed to "open ended" REITs because of the practical problem of valuation.\footnote{147} With traded stocks and bonds there is a daily market value, but with real estate that is not likely to be sold for many years and with no comparable market for establishing value, how does one evaluate the dollar value of a REIT's shares on any given day? A number of suggestions have been advanced by interested parties which call for appraisals or estimates by either trustees or in-

\footnote{143} Reported in the newsletter of Vol. 4, No. 1 National Real Estate Investor (Jan. 1962).

\footnote{144} NAREIF has taken the position that more shareholder control is desirable. This is reported in the N.Y. Times, April 30, 1962, p. 40, col. 3, in a statement by Joseph W. Lund, President of NAREIF.

\footnote{145} See Magruder, The Position of Shareholders in Business Trusts, 23 Colum. L. Rev. 423 (1923).

\footnote{146} This is based upon the theory that the word "fund" has come to have a specialized meaning because of its constant use with the precedent "mutual."

\footnote{147} Wheat & Armstrong, supra note 140, at 929.
dependent appraisers, but at best these evaluations would be guesses, and at worst these methods could be fraudulently abused.

It might prove workable to allow REITs to be "open ended" to the extent that the REIT would offer shares on a monthly or a quarterly price based upon reasonable appraisal value, but this could prove to be very expensive to the REIT.\textsuperscript{148} As far as REITs holding equity interests are concerned, this writer can see no persuasive reason at present for the SEC to reverse its position.

Because of the SEC's denial of "open ended" REITs some REITs have attempted to "avoid" this restriction by registering more shares than they plan to sell at the initial stages and hold these shares for some plan of reinvestment or for a time contract investment plan. In reality, despite the names given to these methods, it is only another form of the initial marketing of the shares.\textsuperscript{149} There are still a limited number of shares available and the price charged for these subsequently acquired shares is fixed by the contract and in no way is it a reflection of fair market value, appraisal value, supply and demand or any other recognized method of establishing an objective price. It is a mere speculation. The existence of these contracts will force the other shareholders of the REIT to assume more of the risk and to receive less of the gain.

By way of illustration, if the shares of the REIT are initially marketed at $10 a share to some investors, while others sign contracts to buy, at their option, so many shares for $10 a share over the next six months, and then so many shares at $10.50 over the next six month period, this will place the risk of loss on the investor who invested $10 at the initial offering period and the fruits to him would be diluted on a per-share basis by the contract-time purchasers exercising his option.

As alluded to previously, mortgage trusts present a different situation in relation to "open ended" trusts.\textsuperscript{150} The problems of valuation are not nearly so great as with equity interests. If a mortgage REIT is buying strictly government insured mortgages (VA, FHA) that yield 5\textsuperscript{1/4}% there is no problem of evaluation at all, and the SEC's argument for preventing this type of REIT from being "open ended" fails completely. The mortgage market, as such, although informal, does give daily or weekly values to dollars invested in certain debt risk situations. If the REIT fixes the rate of return, say at 5%, then all subsequent purchasers of shares in the REIT would be on the basis of the number

\textsuperscript{148} The REIT would have to bear the cost of the appraisals, and if the REIT owned a number of properties and the appraisals were more than a mere sham, this could become a very expensive procedure for the REIT.

\textsuperscript{149} Typical of these names are "divided reinvestment," "time purchase" and "contract purchase."

of dollars necessary to yield 5% on the basis of the earnings of the REIT. For example, if the REIT originally has offered to the public at $10 a share and subsequently earned 75¢ a share, subsequent investors would have to pay $15 a share to receive the 5% return. If, on the other hand, the REIT earned only 40¢ a share, then subsequent investors would pay $8 a share to buy the limitless shares of the REIT. This method is practical and fair to all concerned. It is to be expected that the SEC will approve such a plan or a similar one after it revaluates its present position. Mortgage REITs should be the first truly "open ended" trusts doing business under the Real Estate Investment Trust Act.

VI. REAL ESTATE INVESTMENT TRUSTS AND THE REAL ESTATE MARKET

Real estate in general has been becoming more of a public enterprise in the last few years. Traditionally it was an area precluded from the small investor and often even from the medium size investors. Diversification of risk was almost impossible without the use of large sums of money. In the past several years, syndication has become important in real estate. Some syndicates have become public corporations, while other closely held corporations have also "gone public." The National Real Estate Investor now lists almost one hundred real estate corporations that are publicly held and traded in a national market. The same magazine in a recent issue listed seventeen publicly traded REITs. It is apparent that the public is being invited into the real estate investment field on a wide front. With the traditional high yields in real estate and this new-found marketability and stability investors are rapidly moving into the real estate area.

Most of the new REITs are offering initial subscriptions of from three to twenty-five million dollars. Thus, the REITs are starting as big businesses that are capable of a sizable impact on the national real estate market. As of the first of the year, there were over $230,000,000 in new shares registered or in registration with the SEC. With the issuance of the final Treasury Regulations last May it is not unreasonable to expect this figure to move to over a billion dollars in a year or two. These figures do not even include over $50,000,000 worth of property held by REITs in existence prior to the passage of the Real Estate Investment Trust Act.

151. Vol. 4, No. 6 NATIONAL REAL ESTATE INVESTOR 13 (June 1962).
152. Ibid.
153. The first syndicates offered yields of about 12%, and as syndicates became more widely accepted the yield dropped to about 10%. Real estate corporations, generally, pay 6 to 8% yields, while the REITs dealing in equities are expected to yield about 7 to 8% on the invested dollar.
154. Robert M. Burr, Executive Director of NAREIF, has compiled a list dated Jan. 15, 1962, which was sent to all of the members of NAREIF.
155. See Appendix for a list of REITs in existence prior to 1960.
The small investor will now have a choice of investment vehicles into the real estate field. Of course, the probable short run prospect of all this new money into the real estate field will lead to overpricing of prime income properties and to a reduction of percentage yields in the newly invested dollar. But there is a great amount of real estate in the United States, and it is not likely that supply and demand factors will wreck havoc on the real estate market. When one realizes that one of Congress's avowed intentions in passing the Real Estate Investment Trust Act was to bring private capital into the real estate market, it is obvious that in this respect Congress will have been successful. All of the activity in real estate that has been generated by REITs and the other now popular forms of real estate investment should have a long term beneficial effect upon the growth and economy of the country. The real estate field is ceasing to be alien to the small investor, and this will have the effect of encouraging investments which in turn will bring stability and marketability to real estate assets.

VII. Conclusion

REITs are an old investment form that have been revitalized by a change in the Internal Revenue Code. After a short period of little activity, REITs have been organized at a rapid pace that is now increasing. Each day brings increased interest in REITs. REITs are being used in a number of ways for equity and debt interests, and it is likely that there may develop new uses for REITs. This tremendous financial impact on the real estate market and of investor interest in real estate is in the hands of a few men who are serving as trustees of these REITs. Since the new REITs are unproved and the trust form allows the trustees more freedom than directors of a corporation, a great deal depends upon the vision and integrity of the trustees.

A whole new "industry" is developing and as with anything new there will be "growing pains." Investors must always use considerable caution in investing in anything new and unproved, but for once the "professionals" are attempting to get maximum protection for the investors. The "professionals" are themselves attempting to have reasonable controls placed upon REITs so that in the long run a REIT will be synonymous with sound investments. REITs have started off as big businesses and the future should show them becoming even bigger.

156. The House Ways and Means Committee report may be found at 4 CCH STAND. FED. TAX REP. § 4099A, at 44308 (1962).
APPENDIX
REAL ESTATE INVESTMENT TRUSTS

This list was made as of July 15, 1962. The following symbols are used: \( B \) for Blankcheck, \( E \) for Existing, \( M \) for Mortgage, \( P \) for Purchasing, \( S \) for Exchange, and \( X \) for Mixed.

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