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THE REAL ESTATE INVESTMENT TRUST
COURTESY OF THE LOS ANGELES GOLF CLUB - SECTIONS 856-858 OF THE INTERNAL REVENUE CODE OF 1954

THOMAS G. CODY*

In 1921 James M. O'Brien and T. A. Morrissey made a declaration of trust of certain Los Angeles real estate. The trust was designated the "Los Angeles Golf Club." Morrissey and O'Brien, as trustees of the trust, were authorized to do everything necessary to operate the club. Little did these gentlemen realize the contribution they were about to make to the clarification of the predecessor of section 7701(a)(3) of the Internal Revenue Code of 1954. While section 7701(a)(3) and its predecessor sections¹ include an "association" within the definition of "corporation," the Code has remained silent as to what meaning is to be attributed to the word "association." In 1935, the Supreme Court of the United States filled this void with its decision in Morrissey v. Commissioner of Internal Revenue² wherein the Court analyzed the nature of owner-

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1. INT. REV. CODE OF 1939, § 3797(a)(2); Revenue Act of 1932, § 1111(a)(2); Revenue Act of 1928, § 701(a)(2); Revenue Act of 1926, § 2(a)(2); Revenue Act of 1924, § 2(2)(2); Revenue Act of 1921, § 2(2); Revenue Act of 1918, § 1; Revenue Act of 1917, § 200.

2. 296 U.S. 343 (1935). The Morrissey decision was the first of a series in which the Supreme Court denied "pass-through" treatment to holders of transferable shares of beneficial interest in trusts which acted as collective investment vehicles. The others (all decided the same term) were Swanson v. Commissioner, 296 U.S. 362 (1935) (trust created by co-owners of an apartment building to manage, control, mortgage and otherwise deal with the property held taxable as an association); Helvering v. Combs, 296 U.S. 365 (1935) (trust created to finance and drill an oil well held taxable as an association); Helvering v. Coleman-Gilbert Associates, 296 U.S. 369 (1935) (trust created by owners of various apartment buildings to own and operate the buildings held taxable as an association). The Supreme Court had previously decided what the characteristics of a business trust were in Hecht v. Malley, 265 U.S. 144 (1924). The business trust is, in substance:

... [A]n 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
ship and operational structure of the Los Angeles Golf Club. Faced with a situation involving the use of a trust as a vehicle for real estate investment and development, the Court held that the test for "association" was to be found in the attributes of a corporation. Resemblance to a corporation would result in the "association" being taxed as a corporation. After discussing the various attributes to be considered, the Court held the trust in question to be an association taxable as a corporation.

The immediate result of Morrissey was to mandate the double taxation generally associated with the corporation for the business trust. Consequently, it eliminated the possibility of a pass-through approach whereby all, or substantially all, of the business trust's income would, to the extent distributed, be taxed only at the beneficiary level. This was the state of the law for slightly less than 25 years.

Recognizing that the 1954 Code provided certain conduit treatment for shareholders of regulated investment companies (so-called "mutual funds"), the Congress, in 1960, considered legislation which would extend to holders of shares of beneficial interest in real estate investment trusts substantially the same treatment for federal income tax purposes previously afforded shareholders of regulated investment companies. The Congress held this to be desirable since:

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 property is divided.

Id. at 146-47.

3. 269 U.S. 343 at 359-60. The major attributes of a corporation may be summarized as follows: (a) associates; (b) continuity of life; (c) an objective to carry on business and divide the gains; (d) centralized management; (e) limited liability of shareholders; and (f) free transferability of interests. These criteria, first enunciated in Morrissey, have been spelled out in Treas. Reg. § 301.7701-2 (1960).

4. Pass-through benefits were offered, however, to the shareholders of regulated investment companies during this period. Under §§ 361 and 362 of the Int. Rev. Code of 1939 (presently found in §§ 851, 852 and 855 of the Int. Rev. Code of 1954), regulated investment companies, which include those entities commonly referred to as "mutual funds," could elect to be taxed only on undistributed income, this despite the fact that they were, and are, taxable as corporations. See Int. Rev. Code of 1954, §§ 851 and 7701(a)(3); Int. Rev. Code of 1939, §§ 361 and 3797(a)(3). More specifically, under present law, electing regulated investment companies which (i) meet certain asset and income tests and (ii) distribute at least 90 per cent of their ordinary income are taxed only on their retained earnings. In addition, shareholders are entitled to a credit for any capital gains taxes paid by the company. An attempt in 1956 to enact legislation addressed to real estate investment trusts failed when President Eisenhower vetoed B.R. 4392, 84th Cong., 2d Sess. (1956), in his veto message of August 19, 1956, 102 CONG. REC. 15304 (1956).

5. Id.
In both cases [regulated investment companies and real estate investment trusts] the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources. These advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangement; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly.\(^6\)

It was felt that tax-wise this equalization of treatment would secure "for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate equities and mortgages directly."\(^7\)

With these purposes in mind Congress, in 1960, added sections 856, 857 and 858 to the Internal Revenue Code. In substance, these sections provide that a qualifying and electing real estate investment trust (REIT) shall be exempt from corporate taxes\(^8\) on income which is distributed to its shareholders. Qualification for this treatment is based on satisfying requirements as to (a) amount of income distributed;\(^9\) (b) composition of assets;\(^10\) and (c) sources of income.\(^11\) In essence, the trust will have to distribute 90 percent of its so-called "real estate investment trust taxable income,"\(^12\) invest primarily in real estate and mortgages,\(^13\) and derive the major portion of its income from such real estate and mortgages.\(^14\)

I. Section 856—Definition of a Real Estate Investment Trust

A. General Definition

Section 856(a)(1) of the Code defines a real estate investment trust as a trust which is treated for Federal income tax purposes as a corporation and which...
trust as "an unincorporated association" which: 15

(1) would be taxable as a corporation absent sections 856-858; 15

(2) is managed by one or more trustees;

(3) has transferable shares or certificates of beneficial interest;

(4) does not hold any property primarily for sale in the ordinary course of business;

(5) has 100 or more persons holding beneficial (as opposed to record) interests;

(6) does not have fewer than six individuals owning more than 50 percent in value of the outstanding stock of the REIT; 17 and

(7) meets the income, asset and income distribution tests of section 856(c). The characteristics specified in subparagraphs (1), (2), (3) and (4) above must be met during the entire taxable year in question, while that set out in subparagraph (5) must be satisfied during at least 355 days of that taxable year. 18 While certain of the components of the definition are clear, 19 others require clarification.

B. Management by the Trustees

Section 856(a)(1) requires the REIT be "managed by one or more trustees." In effect, this requires that the trustees have the exclusive authority to make the management decisions necessary to the business operations of the REIT. 20 This is to be distinguished

15. Since the "conduit" treatment offered qualifying and electing REITs is provided solely by statute, strict adherence to its provisions is absolutely necessary. The failure to qualify can lead to immediate and disastrous consequences. The REIT will lose its "pass-through" character and will be subject to tax as a corporation. A tax will be payable on the same income both at the corporate and shareholder levels. If a trust is disqualified after successfully qualifying for several years, it will have distributed most if not all of its income. Consequently, it could be in the unenviable position of having to liquidate investments to meet its corporate tax liability.


17. Section 856(a)(6) of the 1954 Code provides that an organization does not meet the definitional requirements if it "would be a personal holding company (as defined in § 542) if all its adjusted ordinary gross income (as defined in § 543(b)(2)) constituted personal holding company income (as defined in § 543). . . ."

18. Int. Rev. Code of 1954, § 856(b); Treas. Regs. § 1.856-1(c) (1962). A proportionate part of the year is used if the taxable year is less than twelve months.


from the ordinary concept of the trustee of an inter vivos or testamentary trust where the trustee takes title to the property in trust but solely "for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."21 The result of this requirement is that the trustees of an REIT must satisfy the "centralization of management" test set out by section 301.7701-2(c) of the Treasury Regulations.22

Realizing the enormous financial impact a failure to qualify as a REIT will have on the trust,23 and conceding that it is consequently essential that the REIT scrupulously observe each of the various criteria of section 856(a), the question arises as to what powers can remain in hands of the holders of shares of beneficial interest without risking a finding that the trustees are not managing the business? There has been a dearth of authoritative interpretation on this statutory requirement. The regulations and a few published revenue rulings offer some assistance. In section 1.856-

1(d)(1) of the regulations, the Treasury states that certain powers may be left to the shareholders. Noting that the following are merely meant to be examples of permissible retained powers, the regulation states that the requisite continuing exclusive authority of the trustees will still exist:

22. Treas. Reg. § 301.7701-2(c) (1960) provides in relevant part:

Centralization of Management. (1) An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. Thus, the persons who are vested with such management authority resemble in powers and functions the directors of a statutory corporation. . . .

(2) The persons who have such authority may, or may not, be members of the organization and may hold office as a result of a selection by the members from time to time, or may be self perpetuating in office. See Morrissey v. Commissioner 296 U.S. 344 (1935) [36-1 USTC ¶9020]. Centralized management can be accomplished by election to office, by proxy appointment, or by any other means which has the effect of concentrating in a management group continuing exclusive authority to make management decisions.

(3) Centralized management means a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization. Thus, there is not centralized management when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal.

(4) There is no centralization of continuing exclusive authority to make management decisions, unless the managers have sole authority to make such decisions. For example, in the case of a corporation or a trust, the concentration of management powers in a board of directors or trustees effectively prevents a stockholder or a trust beneficiary, from binding the corporation or the trust by his acts. . . .

23. See notes 8 and 15, supra.
Even though the trust instrument grants to the shareholders any or all of the following rights and powers: To elect or remove trustees; to terminate the trust; and to ratify amendments to the trust instrument proposed by the trustee.

Additional examples of these permissible retained powers are found in Revenue Ruling 70-569. There, the declaration of trust endowed the trustees with very broad management powers over the assets and affairs of the REIT. In addition, the declaration specifically conferred the following rights on the holders of shares of beneficial interest:

1. the right to approve or refuse to approve an increase in the rate of the trust adviser’s compensation;
2. the right to approve or refuse to approve any proposed merger of the trust into another organization; and
3. the right to approve or refuse to approve any sale or other transfer of substantially all of the property of the trust.

Without stating any reasons for its decision, the Internal Revenue Service ruled that these rights did not violate the requirement of section 856(a)(1) that the trust be managed by one or more trustees.

In the same vein as the question of how much control may be retained by the REIT shareholders is the concern as to how much authority the trustees can delegate without risking disqualification on the ground that they are not managing the trust as required by section 856(a)(1). The Internal Revenue Service has focused on this issue and has ruled that:

[T]rustees have powers similar to those possessed by direc-

26. The facts posited in this ruling were as follows:
P, an unincorporated trust, otherwise qualifying as a real estate investment trust under § 856 of the Code, has an agreement with an advisory company under which the company advises the trust with respect to investments and investment policy and administers the day-to-day operation of the trust, subject to the supervision of the trustees of the trust. Under a delegation of authority from the trustees, the company is authorized to make loan commitments and investments on behalf of the trust up to a specific amount, subject to the policies and guidelines set forth in the declaration of trust. Loans above the specific amounts must be approved by the trustees. The trustees retain all other continuing exclusive authority to manage the trust. The delegation of authority, which is for an initial term of two years, is permitted under applicable state law and is subject to approval of the shareholders. It may be terminated by the trustees upon 60-day notice. 1972-1 Cum. Bull. at 207.
tors of a corporation and since the board of directors of a corporation generally has the power to delegate discretionary power to an agent, the trustees of a real estate investment trust possess the same power.27

By way of analogy, the resemblance of corporate directors and REIT trustees can be extended to the shareholder-retained power issue. The permissible retained powers found in the regulation cited and revenue ruling discussed are limited in scope. Considered in context, however, it would seem permissible to conclude that those powers and rights normally held by corporate shareholders could also be retained by holders of shares of beneficial interest without substantial risk of disqualification.28

C. Active Business Prohibition

Congress, in considering the merits of adding the REIT provisions to the Code, emphasized that there was no intent to provide conduit treatment to those organizations which were no different, except as to product, from the conventional business organization. The benefits of REIT treatment were to be restricted to those trusts which were organized for the investment pooling arrangements originally contemplated by the Congress.29 The Report of the House Committee on Ways and Means contains the following language:

. . . [Y]our committee has . . . taken care to draw a sharp line between passive investments and the 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 investment trusts. Your committee believes that any real estate investment trust engaging in active business operations should continue to be subject to the corporate tax in the same manner as is true in the case of similar operations carried on by other comparable enterprises.30

Reflecting this objective, section 856(a)(4) bars favorable treatment for a trust which holds "any property primarily for sale in the ordinary course of business." Before discussing the application

28. Unfortunately, the use of the word "normally" automatically implies a question of fact. As a result, in view of the consequences of a failure to qualify, a private ruling should be sought from the Internal Revenue Service before adding any retained powers other than those previously sanctioned by the regulations or published revenue rulings.
29. See text accompanying note 6, supra.
30. See note 6, supra.
of this provision, it must be noted that the Code refers to *any* property. As a result, disqualification is not dependent upon a finding that the trust holds all or substantially all its property as inventory, but can occur whenever the trust is deemed to hold a single fee interest, a single mortgage, or a single lease for sale in the ordinary course of business.

Regulations in effect under section 856(a)(4), those proposed and a recent revenue ruling delineate the stringent nature of this provision. Section 1.856-1(d)(4) of the regulations provides:

> A real estate investment trust may not hold any property primarily for sale in the ordinary course of its trade or business. Whether property is held for sale to customers in the ordinary course of the trade or business of a real estate investment trust depends upon the facts and circumstances of each case.

A recent ruling indicates the depth of the concern that the meaning of this provision has created. In Revenue Ruling 72-229, the Internal Revenue Service was asked to determine whether the "property primarily for sale" test would be met if a REIT issued its own commercial paper in the form of promissory notes. The Service concluded that since the REIT itself was merely borrowing money from those who purchased the notes, the trust was not holding property primarily for sale to customers in the ordinary course of business. It was conspicuously noted in the ruling that the bank which acted as the trust's selling agent had "no liability for payment of the notes and is not accountable for the collectibility, validity or enforceability of any check delivered in payment for the notes and has no liability in connection with the notes."  

Two observations are appropriate. First, the mere fact of applying for a ruling in connection with this financing practice illustrates the concern of the trust's management to avoid, if possible, any risk of running afoul of the section 856(a)(4) test. Secondly, and perhaps more significantly, the reliance placed on the absence of an independent or joint obligation on the part of the agent bank illustrates the danger of inadvertent disqualification. A joint or independent obligation of the agent bank could, it appears, have created "property" solely for sale to the public and resulted in disqualification.

One of the "property primarily for sale" problems which has

32. *Id.* at 207.
caused great concern to trusts attempting to qualify under the section 856 definition is that generated by the sale of mortgage participations. Assume, for example, that a builder approaches a trust with a request for a $50,000,000 loan to be secured by a mortgage on real property. Assume further that the trust is unable (because of restrictions in its declaration of trust) or unwilling to commit for and fund the entire $50,000,000. What options are available to it? Clearly, if the trust merely agrees to lend a portion of the amount requested and then finds other lenders who will take up the balance, no problem should exist. Equally clear is the situation where the trust lends the $50,000,000 intending to sell participations in the loan after closing. Here the trust does hold property and that property is held as inventory at least to the extent of the participations. A subsequent sale would probably disqualify the trust. But what if the trust does lend the entire $50,000,000 and several years later, because better investments become available, sells or "lays-off" a part of the loan? Until very recently, there was no published answer to this question.

In Revenue Ruling 73-398, the Internal Revenue Service replied that where the trust has no history of portfolio sales and no intent to engage in further selling, their investment policy having resulted in a severe portfolio imbalance and such imbalance has affected its access to additional funding sources a sale may be made. Under these circumstances, to dispose of several long-term mortgages to balance its investments will not result in a finding that the mortgages were held primarily for sale within the meaning of section 856(a)(4). Concededly, the ruling is of limited value as precedent in situations other than that described. Nevertheless, it does indicate a realistic attitude on the part of the Service when faced with the facts of business life with which the trust must deal such as changes in market conditions, sources of funding and the like.

On December 7, 1972, the Treasury published certain proposed regulations wherein it included several examples of what was meant by the limitation on property held for sale in the ordinary course of business. Section 1.856-1(d)(4) of the Proposed Treas-

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34. Proposed Treas. Reg. § 1.856-1(d)(4), 37 Fed. Reg. 26014 (1972), includes in example (1) the factual statements that the condominium is "listed with a broker for sale as an individual unit" and is "sold to an unrelated party within a reasonable period of time." (Emphasis added) As a result, the examples, which apparently attempt to describe certain
sury Regulations contains two examples, both of which indicate the Service considers that: (1) when Congress said "any property" it means "any", and (2) a trust acts at its peril when it does any more than attempt to protect its investment in, or reduce its loss with respect to, a particular asset. The proposed regulation provides in relevant part:

Example (1). Trust M, which otherwise qualifies as a real estate investment trust, has in its portfolio a construction loan for a condominium (single multi-unit dwelling). The loan originated with the trust and was made in accordance with prudent lending practices. The security for the loan is a mortgage on the condominium. After completion of the construction of the condominium, the debtor defaults on the loan and the trust becomes the owner of the condominium as a result of a foreclosure sale. The condominium is listed with a broker for sale as an undivided unit. The condominium is sold to an unrelated party within a reasonable period of time after foreclosure of the mortgage. . . . [T]he trust is not considered to have held the condominium primarily for sale to customers in the ordinary course of its trade or business merely because of the circumstances under which the foreclosure was made and the property was sold.

Example (2). The facts are the same as in Example (1), except that, at the time the trust obtains ownership of the condominium, the construction . . . is 80 percent completed . . . and the trust employs an unrelated contractor to complete construction of the condominium.

. . . [T]he trust is not considered to have held the condominium primarily for sale to customers in the ordinary course of its trade or business merely because of the circumstances under which the foreclosure was made and the property was sold.

Both of these examples acknowledge that a REIT, to avoid disqualification, need not conduct a "fire sale" whenever it becomes the owner of the property securing its loan. The examples

transactions which will be "safe," raise several additional and less than obvious questions. Will a trust which accepts the security in satisfaction of the debt without instituting foreclosure proceedings be barred from relying on example (1)? If a building were 79% complete, or 51% complete at the time of foreclosure, could any reliance be placed on example (2)? In substance, must a trust literally fit within the examples in order not only to rely but also to avoid the possibility of an agent interpreting them as definitive guidelines as to when a trust will and when it will not satisfy section 856(a)(4)? A more complete discussion of these problems is found in Berenson & Reichler, The Proposed REIT Regulations: A Critique, 73 THE TAX ADVISER 282 (1973). These commentators characterize the clarifying effect of the proposed regulations as follows: "We believe that the mountain has labored long and brought forth a mouse." Id. at 283.
similarly indicate, however, that even though a sale as an entirety might produce less income than a sale in units, the REIT must nonetheless avoid holding the property as inventory.

The narrowness which the Service views the "primarily for sale" requirement mandates that a trust and its counsel think at least twice before planning any investment program which could (because of portfolio turnover) be viewed as including inventory among its investments.

**D. Income and Asset Requirements**

Assuming that the trust has satisfied the definitional requirements of subdivisions (1) to (6) of section 856(a), it must still meet the income and asset composition tests of section 856(c) before it can qualify to elect REIT treatment.

1. **Income Test**

   There are two positive and one negative income tests. The 75 percent income test\(^3\) provides that at least 75 percent of the trust's gross income\(^3\) must be income related to real property. This includes: (i) rents from real property; (ii) interest on obligations secured by mortgages on real property; (iii) gain from the sale or other disposition of real property; (iv) dividends and other distributions from, and gains from the sale or other disposition of shares of other qualifying and electing REITs; and (v) abatements and refunds of taxes on real property.

   Under the 90 percent income test\(^4\) an additional 15 percent of the trust's gross income must be derived from: (i) any of the sources satisfying the 75 percent test; (ii) dividends; (iii) interest; and (iv) gains from the sale of stock or securities.

   The third test, the 30 percent income test requires not more than 30 percent of the trust's gross income may be attributable to: (i) sales or other dispositions of stock or securities held for less than six months; and (ii) sales or other dispositions of real property

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35. INT. REV. CODE OF 1954, § 856(a)(7).
36. INT. REV. CODE OF 1954, § 856(c)(3).
37. INT. REV. CODE OF 1954, § 61(a) defines gross income as "... all income [other than that specifically excluded] from whatever source derived...".
38. This does not mean that the "property primarily for sale" prohibition of § 856(a)(4) is waived if the property involved is real property. Section 856(c) is merely setting forth requirements as to the permissible "mix" of income and assets.
39. Section 856 of the 1954 Code permits a trust to qualify and elect REIT treatment even if its sole asset and source of income is shares of other qualified and electing REITs.
40. INT. REV. CODE OF 1954, § 856(c)(2).
41. INT. REV. CODE OF 1954, § 856(c)(4).
and interests in real property held for less than four years.\(^{42}\)

2. Asset Test

The following composition of assets must exist at the close of each quarter of the taxable year under the 75 percent asset test.\(^{43}\) At least 75 percent of the total value\(^{44}\) of the assets of the trust must be attributable to: (i) real estate assets; (ii) cash and cash items (including receivables); and (iii) government securities.

The 25 percent asset test\(^{45}\) provides that at the close of each quarter: (i) not more than 25 percent of the trust’s assets may be composed of securities not includable in the 75 percent test above;\(^{46}\) and (ii) with respect to the securities included in this 25 percent test not more than 5 percent of the value of the trust’s total assets may be invested in securities of any one issuer, nor may the trust own more than 10 percent of the voting securities of such issuer.\(^{47}\)

A change in the value of various assets will not in itself cause the 75 percent or 25 percent tests to be failed. However, a security purchase made after value fluctuations have occurred can only be

\(^{42}\) Gross income attributable to real property (or interests in real property which is "compulsory, or involuntarily converted," as that phrase is used in § 1033 of the 1954 Code) is not to be taken into account in applying this 30% test. Int. Rev. Code of 1954, § 856(c)(4)(B).


\(^{44}\) For purposes of §§ 856 to 858, "value" is defined as follows: The term ‘value’ means, with respect to securities for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the trustees, except that in the case of securities of real estate investment trusts such fair value shall not exceed market value or asset value, whichever is higher. Int. Rev. Code of 1954, § 856(c)(6)(A).


\(^{46}\) This limitation does not apply to shares of other qualified and electing REITs. Treas. Reg. § 1.856-3(c) (1962) provides that the term "securities" does not "include ‘interests in real property’ or ‘real estate assets’ as those terms are defined, in § 856. . . . “Section 856(c)(6)(B) of the Code and § 1.856-3(b) of the Regulations include shares of other qualified and electing REITs within the meaning of real estate assets. Treas. Reg. § 1.856-3(f) (1962) contains a definition of “qualified real estate investment trusts.”

\(^{47}\) Treas. Reg. § 1.856-2(d)(4) (1962) contains an example of a trust which, while satisfying the 75 % test, fails the 25 % test:

Example (2). Real Estate Investment Trust P, at the close of the first quarter of its taxable year, has its assets invested as follows:

<table>
<thead>
<tr>
<th>Percent</th>
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<tbody>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Gov't Securities</td>
</tr>
<tr>
<td>Real Estate Assets</td>
</tr>
<tr>
<td>Securities of Corporation Z</td>
</tr>
<tr>
<td>Securities of Corporation X</td>
</tr>
</tbody>
</table>

TOTAL 100
made when these tests are satisfied after taking the fluctuations into account. The same principle applies to the 5 percent test contained in the 25 percent test.48

E. Specific Items to be Considered in Applying the Income Tests

While the application of the asset composition test is fairly straightforward, there are several problems arising in connection with the income tests.

1. Rents from Real Property

As a general rule, the term “rents from real property” refers to the price paid to use real property owned by the trust. Unfortunately, as is the case with many sections of the Code, more emphasis must be placed on and concern shown for the exceptions added to this general rule.

Both real and personal property rented by the trust. Where a trust receives gross income with respect to the use of both real and personal property only the amount paid with respect to the real property can be used to satisfy the 75 percent test.49

Rents dependent on the income or profits of any person. Amounts received as rent which are determined wholly or partially by reference to the income or profits derived by the lessee from the property do not qualify as “rents from real property.”50 This bar does not extend to those rents which are based on a percentage of the lessee’s gross receipts or gross sales.51 The difficulty with the provision disqualifying income-based rent is not the theory under which it arises but its practical application. The incentive to participate in the lessee’s business which profit participation can offer, would seem to justify barring these amounts. However, the application of the principle in the regulations indicates a certain inconsistency in approach. Under regulation section 1.856-4(b)(1) rent which is a fixed amount qualifies. Rent which is based on income or profits does not. But what if the rental amount is based on a

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Trust P meets the requirement of § 856(c)(5)(A) since at least 75 percent of the value of the total assets is represented by cash, government securities, and real estate assets. However, Trust P does not meet the diversification requirements of § 856(c)(5)(B) because its investment in the voting securities of Corporation Z exceeds 5% of the value of the trust’s total assets.

49. Treas. Reg. § 1.856-4(a) (1962). Such would be the case where the trust owned and rented a furnished apartment building.
50. INT. REV. CODE OF 1954, § 856(d)(1).
51. Id.
combination of both fixed and profit-sharing amounts? Is the sum tainted? The regulations provide an unequivocal "it depends!"

Where in accordance with the terms of an agreement an amount received or accrued as rent for the taxable year includes both a fixed rental and a percentage of the lessee's income or profits in excess of a specific amount . . . neither the fixed rental nor the additional rent will qualify as 'rents from real property.'

This would seem logical in view of the language of section 856(d)(1). What if the trust, pursuant to this formula of fixed rent plus a percentage of profits, determines that in fact this year's rent is to be merely the fixed amount since the necessary profit level was not reached by the lessee? Logically, the fixed rent should also be disqualified since it was a part of a total package which included a profit component. The mere absence of profits in one year should be irrelevant if the purpose of the section is to isolate the trust from an incentive to participate in the lessee's business. This is not the case. Section 1.856-4(b)(1) of the regulations continues, "However, where the amount received or accrued for the taxable year under such an agreement includes only the fixed rental . . . such amount may qualify as 'rents from real property.'" The proposed regulations leave this distinction intact.

Trust ownership of the person from whom it receives rent. Rents from real property do not include any amount which is accrued or received by the trust from a person or corporation in which it has a 10 percent or more interest.

Trust must furnish services and manage property only through an independent contractor. Section 856(d)(3) provides in relevant part that "rents from real property" does not include "any amount received or accrued, directly or indirectly, with respect to any real property, if the real estate investment trust furnishes or renders services to the tenants of such property, or manages or operates such property, other than through an independent contractor from

53. Treas. Reg. § 1.856-4(b)(1) also points out that an inadvertent tainting of rents can occur where the trust leases property on an otherwise qualified percentage of gross receipts basis. If the tenant subleases all or a part of the property on a percentage of profits basis, the entire rent paid by the first lessee to the trust is tainted. As a result, trust counsel, in drafting the lease should bar its lessee from subleasing in any way which would cause rental payments to fail the "rents from real property" test.
55. INT. REV. CODE OF 1954, § 856(d)(2).
whom the trust itself does not derive or receive any income." This provision, which again reflects the Congressional concern that the trust be an investor and not an entrepreneur, effectively bars the trust from any direct or indirect operation of its own property.

Though apparently lacking authority in the Code, the regulations add a further complication by distinguishing between "services . . . usually or customarily furnished or rendered in connection with the mere rental of real property" and "services other than those usually or customarily rendered. . . ." The regulations provide that where customary services are performed for tenants of the trust's real property, the cost of these services may be taken up by the trust and, insofar as the rent includes them, may be charged back to the tenants. In this case, no apportionment is required to be made between the actual real property rental amount and the amount representing payment for these services. On the other hand, where the services are not customary, the trust cannot absorb their cost. The entire cost must be separately billed for and absorbed by the independent contractor, and the amounts must be received and kept by the independent contractor. If the requirements are not literally met, or an "erroneous" determination of what is customary is made, the total rent received is excluded from the "rents from real property" category.

56. Section 856(d)(3) of the 1954 Code defines an independent contractor as:

(A) a person who does not own, directly or indirectly, more than 35% of the shares, or certificates of beneficial interest, in the real estate investment trust, or

(B) a person, if a corporation, not more than 35% of the total combined voting power of whose stock (or 35% of the total shares of all classes of whose stock), or,

if not a corporation, not more than 35% of the interest in whose assets or net profits is owned, directly or indirectly, by one or more persons owning 35% or more of the shares or certificates of beneficial interest in the trust.

The section concludes by adding that in applying the 35% test, the constructive ownership rules of § 318 are to be applied with one modification - the 50% tests of § 318 are to be replaced by a 10% test.


59. The regulation provides certain examples of what might be "customary services" depending upon the circumstances. This should be contrasted with non-customary services as to which the Treasury provides examples of what definitely are not customary. See note 60, infra. The result (and this is perpetuated by the Proposed Treas. Reg. § 1.856-4(b)(3)(i)(b), 37 Fed. Reg. 26014 (1972)) is to set up two categories - perhaps and absolutely not. Examples of services which may or may not be customary are: the supplying of water, heat and light; the cleaning of windows, exits and public entrances; trash collections; elevator service; answering service; unattended parking lots and the like.

60. Treas. Reg. § 1.856-4(b)(3)(i)(c) (1962) lists the following as non-customary services: hotel, maid, boarding house, motel, attended parking lot, warehouse or storage services.

61. See note 58, supra.
2. Interest on Obligations Secured by Mortgages on Real Property or Interests in Real Property

An interest on obligations secured by mortgages on real estate qualifies in determining whether the 75 percent gross income test has been met. No other type of interest qualifies. While the Code does no more than state that such interest must be mortgage-related, the regulations, several rulings and the facts of REIT life have given rise to a variety of questions as to the application of this critical test. The majority of these questions arise in connection with direct charges by and/or borrower reimbursement to the trust for the expenses incurred by the trust in connection with its financing transactions. Discussed below are some of the more frequently encountered problems in this area of "good", or 75 percent test, interest.

Legal interest. Section 1.856-2(c)(2)(ii) of the regulations bars all but "lawful interest" from meeting the 75 percent test. Consequently, usurious or otherwise illegal interest does not qualify. Obviously, this can create substantial risks for a trust whose financing activities extend into many jurisdictions. The statutory and theoretical basis for this interpretation is less than clear. Although this provision has been omitted in the proposed regulations as published, a trust while awaiting their final promulgation must still run the risk that a loan's interest may be usurious and unqualified for the 75 percent test. It is understood that the Internal Revenue Service's informal position is that only the illegal portion of the interest fails to qualify.

Interest on a note secured by a mortgage on both real and personal property. The regulations require (as is the case with

62. Section 856(c)(6)(C) of the 1954 Code defines the term "interests in real property" as including "fee ownership and co-ownership of land or improvements thereon and leaseholds of land or improvements thereon, but does not include mineral, oil, or gas royalty interests."

63. Other types of interest do qualify for the 90% test of § 856(c)(2).


65. One commentator feels much more strongly, stating: "The provision of section 1.856-2(c)(2)(ii) of the regulations that "usurious or illegal interest" on a real estate mortgage, is so wrong it would be amusing if less were at stake or if it were possible to say with assurance what is and what is not usurious under the bewildering variety of statutes and decisions on that question." Carroll, Tax Policy for the Real Estate Investment Trusts, 28 TAX L. REV. 299, 309, n.29 (1973).

rents) that an apportionment be made where a loan is secured by both real and personal property. Until the proposed regulations were published, the regulations were silent as to how this apportionment should be made. Under the proposed regulations, if the loan value of the realty equals or exceeds the amount of the borrowing and equals or exceeds the loan value of the other property securing the loan, the interest will be apportioned entirely to the realty. The interest will therefore qualify in full for the 75 percent test. For example, if a trust lends $25,000,000 to a corporation which owns and operates a chain of hotels, the loan being secured by a mortgage on the corporation's land, buildings and chattels, the interest paid will qualify for the 75 percent test if the owner's equity in the land and buildings is at least $25,000,000 and the value of the chattels is less than that amount. If, on the other hand, the value of the chattels were $30,000,000, and the value of the land and buildings $24,000,000, the interest would be apportioned in its entirety to the personal property. As a result, none of the interest would qualify for the 75 percent test. Finally, if the relative loan values of the real property and the chattels do not cause the transaction to fall within either of these two alternatives, the interest income is to be apportioned on the basis of the relative values of the real and personal property.

Interest dependent wholly or partially on the income or profits of another person. As noted above, the term "rent from real property" does not include any rent which is based in whole or in part on a lessee's (or sublessee's) profits or income. The regulation establishing this "tainting" has specific support in the Code. In the proposed regulations, the "taint" has been extended to interest income which is determined by the borrower's income or profit picture. There is not statutory authority for this approach to interest and, in fact, the statute introduces this limitation only with respect to rents. If the new limitation is the result of the Treasury's fear that the absence of this limit is a loophole permitting a trust's indirect involvement in the business of its borrowers, it would seem

67. Id.
68. Id. The disqualified interest would, however, qualify for the 90% test of § 856(c)(2) of the Code.
69. Id.
70. See text accompanying note 50, supra.
72. INT. REV. CODE OF 1954, § 856(d)(1).
that the general active business prohibition which permeates section 856 is a sufficient deterrent given the disastrous consequences of disqualification.74

**Guaranteed interest; temporary purchases of mortgages.** Assume that Bank A has loaned $25,000,000 to X, a corporate borrower, at an interest rate of 8 percent. The loan is secured by a mortgage on real property. Assume further that, at a later date, for valid business reasons, the bank would like to reduce this investment. Trust B, an otherwise qualified and electing REIT, is willing to “buy” $10,000,000 of this loan but only if it can receive interest at an effective rate of 9 percent. Two options are available. If Trust B merely purchases $10,000,000 of the loan and Bank A agrees to share the interest received on the mortgage in a manner which will guarantee Trust B a yield of 9 percent, the interest should qualify whether it is treated as interest or market discount. Suppose, however, that Bank A guarantees that the trust shall receive no less than 9 percent. In the alternative, suppose that the bank does not wish to part forever with this investment, but merely wishes to remove a portion of it from its portfolio for a limited time. The answer is based on another question as to who is the borrower-in-fact. Is it really interest on a loan secured by real property or is it a loan to Bank A which is secured by Bank A’s assets, the notes and mortgages which it continues to own? If the answer is the latter, the interest, since it is not based on a real property transaction, fails the 75 percent test although it will qualify as other interest for the 90 percent test.75

**Points.** Revenue Ruling 70-54076 defines “points” as follows:

The term “points” . . . refers to a charge made by the lender to the borrower, which is in addition to the stated annual interest rate, and is paid by the borrower to the lender as an adjustment of the stated interest to reflect the actual cost of borrowing money. The amount of “points” charged is determined by the lender upon consideration of the factors that usually dictate an acceptable rate of interest. Thus “points” . . . are for the use or

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74. See note 15, supra.

75. Situations where the seller intends to “buy back” the participation is what is generally called a “warehousing” transaction. In effect, the seller is saying: “Look, I need some funds for a limited period of time. You lend me the money and hold these assets of mine as your collateral. After the need passes, I'll buy it back.” See Special Ruling, June 18, 1963, 637 CCH ¶6559 where the Internal Revenue Service privately ruled that such interest qualifies only for the 90% test.

forbearance of money and are considered to be interest.\textsuperscript{77} (Emphasis added.)

While the Service's position that points are "good" interest for the 75 percent test is reasonably straightforward, two problems remain. If the points are to be paid at a certain date prior to the closing, there is a substantial question as to whether the income is generated by an obligation secured by a mortgage on real property.\textsuperscript{78} Prior to closing, there is no loan; there is no obligation; there is no mortgage. There is at least cause for concern that the income will not be interest for the 75 percent test, but rather will be viewed as a non-qualified commitment fee.\textsuperscript{79} Consequently, a trust would be well advised to structure its receipt of points either at the closing or at a time so near to closing that it is in fact part of the process of closing.

A second problem involves a question of when the points are to be included in the REIT's gross income - a matter which can be of some importance in determining whether the trust has distributed 90 percent of its real estate investment trust taxable income.\textsuperscript{80} Assume that Trust X had agreed to lend $1,000,000 to a certain borrower and will charge one point or $10,000. Two methods are available for collecting the $10,000. The trust and the borrower can exchange checks at the closing (the "gross points" approach) or the trust can deliver a check for $990,000 and receive back the borrower's note for $1,000,000 (the "net points" approach). Using the gross points approach results in the trust including the amount when received as a cash basis taxpayer or when the right to receive is fixed as an accrual basis taxpayer.\textsuperscript{81} If the net points approach is adopted, the trust must include the points in gross income ratably over the period during which payments on the note are due.\textsuperscript{82}

Miscellaneous receipts: commitment fees; good faith deposits; legal appraisal, title insurance, recording, credit inspection and similar fees. A commitment fee is a charge for promising to hold funds for the borrower. It is not interest for either the 75 percent

\textsuperscript{77} A "point" is equal to 1\% of the amount borrowed and is paid normally at closing.
\textsuperscript{78} See Rev. Rul. 56-136, 1956-1 Cum. Bull. 92 which provides that the indebtedness must be funded before "points" will constitute interest.
\textsuperscript{79} It is understood that this is the unpublished position of the Internal Revenue Service. See Klein, \textit{Tax Problems of Mortgage Investment Trusts}, \textit{The Mortgage Banker} 23 (Oct., 1971).
\textsuperscript{80} See text accompanying note 91, \textit{infra}.
\textsuperscript{81} See Rev. Rul. 70-540, note 76, \textit{supra}.
\textsuperscript{82} Id.
or 90 percent tests. As a result it is included in the 10 percent basket clause for all bad or tainted income. A commitment fee need not be called a fee. If the potential lender is charging for the availability of funds, the amount will retain its taint and not be "good" interest.\textsuperscript{83} For example, if in February X Trust agrees to lend a developer $500,000 in June and assesses a non-refundable point regardless of the ultimate completion of the transaction, that $5,000 charge is a commitment fee.

Normally, when a potential borrower approaches a trust to apply for a loan, the borrower's application will be accompanied by a check representing an application fee for the loan or a good faith deposit. Questions arise as to the treatment of this amount. Clearly, if the trust receives the funds and has no obligation to refund them, the trust has gross income at that time. Just as evident is the fact that this amount is not paid for the use of borrowed funds and therefore does not qualify as interest for either the 75 percent or 90 percent tests. Recalling that these tests are based on gross income,\textsuperscript{84} it is unavailing if the trust agrees to refund the deposit in the event the loan closes. The trust has complete dominion and control over the funds and would have gross income when received. The potential repayment, even in the same tax year, would do no more than create a deduction when repayment occurs. The deduction, of course, is irrelevant in determining gross income.

Two options are open to a trust seeking to avoid this tainted income, both of which are based on an escrow agreement. If the trust, or its adviser, receives the funds in escrow under an agreement whereby the funds do not belong to the trust unless and until the loan is accepted \textit{and} the borrower decides not to close, the position that the deposit or fee constitutes gross income should be severely weakened during the interim before the borrower opts to withdraw. A second alternative is available to those trusts using advisory companies as originating agents for loans. In this situation, the adviser would receive the escrow deposit (not as agent for the trust). In the event of a failure to close, the adviser could keep this amount as part of its compensation thereby avoiding any sub-

\textsuperscript{83} Rev. Rul. 70-362, 1970-2 Cum. Bull. 147. The position of the Service is that these fees represent payment for a service rendered by the trust. Consequently, under § 1.856-2(c)(2)(ii) of the regulations these are "fees imposed upon a borrower which are in fact a charge for services in addition to the charge for the use of borrowed money" and therefore not "good" interest.

\textsuperscript{84} Int. Rev. Code of 1954, § 856(c)(2) and (a)(3).
stantial question of gross income to the trust.

As is the normal case when a bank or other institution lends money, a borrower from a REIT will more often than not be expected to pay directly or reimburse the trust for various expenditures incurred in processing the loan and analyzing both the property involved and the credit status of the borrower such as legal, credit inspection and similar fees. If the trust charges the borrower directly for these "services", "bad" income subject to exclusion results. If the borrower pays these items indirectly, it is apparently the Service's position that these amounts will not be income subject to exclusion.\textsuperscript{85} This would extend to the cost of all items which could be said to reasonably constitute conditions precedent to the trust's obligation to lend.

With respect to counsel fees a more substantial problem exists. In order to justify a borrower's payment of expenses, the particular expense in question must be related to services performed for the borrower to enable him to qualify for the loan. If, as is the normal case, the trust is requiring the borrower to pay for services of the trust's counsel in preparing papers and the like, it is difficult, if not impossible, to argue that such counsel is really representing the borrower. As a consequence, the question of income to the trust becomes inevitable. To resolve this difficulty, it is suggested that the trust factor these costs into its determination of the stated rate of interest or the number of points charged.\textsuperscript{86} Rendered as a part of interest or points, the trust should have qualifying 75 percent test interest.

3. 30 Percent Income Test

Despite the fact that a trust fits within the income boundaries established by the 75 percent and 90 percent tests, it must still satisfy a negative test if it is to qualify. Section 856(c)(4) imposes a further restriction on the securities gains which qualify for the 90 percent test\textsuperscript{87} and the real property disposition profits which fit within the 75 percent test.\textsuperscript{88} Not more than 30 percent of the trust's gross income may be derived from real property dispositions and short-term capital gains. While the implication of this section is

\textsuperscript{85} Oliense, Real Estate Investment Trusts - Problems and Opportunities, Practicing Law Institute: Transcript Series, Real Estate Law and Practice, No. 17 (1973) at 27.

\textsuperscript{86} Id.

\textsuperscript{87} Int. Rev. Code of 1954, § 856(c)(2)(D).

\textsuperscript{88} Int. Rev. Code of 1954, § 856(c)(3)(C).
that long-term capital gains will always meet the 90 percent and 30 percent tests, and that long-term capital gains arising from real property held for four years or more will always meet the 75 percent and 30 percent tests, it must be emphasized that these income tests are quantitative tests. If any of the income items involved in the 30 percent test are attributable to property held “primarily for sale,” immediate and total disqualification occurs.  

II. TAXATION OF REAL ESTATE INVESTMENT TRUSTS AND THEIR SHAREHOLDERS

If a trust meets the definitional requirements of section 856, it will be taxed as a real estate investment trust if it distributes 90 percent or more of its “real estate investment trust taxable income” for the taxable year.  

A. Real Estate Investment Trust Taxable Income

Section 857(b)(2) of the Code defines “real estate investment trust taxable income” as the taxable income of the trust, adjusted as follows:

1. reduced by any excess of net long-term capital gains over net short-term capital losses;
2. increased by any deductions for dividends received, dividends paid, tax-exempt interest and the capital gains portion of the dividends paid deduction of section 561, all of which would otherwise be used in computing taxable income;
3. increased by any net operating loss deduction used in computing taxable income; and
4. computed without regard to the change of accounting period computation provided in section 443(b). In effect, the Code directs computation of taxable income as a corporation, increased or reduced by the items listed in (1) through (4) above.

89. INT. REV. CODE OF 1954, § 856(a)(4).
90. For a discussion of alternatives to this disqualification effect (“sudden death”) see Carroll, Tax Policy for the Real Estate Investment Trusts, 28 TAX L. REV. 299 (1973).
92. "Taxable income" is defined in § 63 of the Code as gross income, minus allowable deductions.
93. INT. REV. CODE OF 1954 §§ 243, 244 and 245.
95. INT. REV. CODE OF 1954, § 172. As a result of this denial of the net operating loss deduction, it is not uncommon for a trust in its earlier, loss-producing stage, to consciously avoid qualifying under §§ 856-858 to permit use of these losses.
B. 90 Percent Distribution Requirements

After computing the real estate investment trust taxable income for the taxable year, a further adjustment is required to determine what amount must be distributed to shareholders. Section 857(b)(2)(C) requires that taxable income be reduced for ordinary income dividends paid to shareholders. Section 857(a)(1) provides that this deduction must equal 90 percent or more of the trust's real estate investment trust taxable income prior to taking that deduction into account. Consequently, in determining whether a trust qualifies because it has, in addition to satisfying the section 856 definitions, distributed 90 percent or more of its real estate investment trust taxable income, one must first compute taxable income, increase it by the dividends paid deduction and then apply the 90 percent distribution test to that adjusted figure. For example, if the real estate investment trust taxable income of Trust A, computed under section 856(b)(2), were $1,000,000 and the section 856(b)(2)(C) deductions were $4,000,000, the trust would not have satisfied the 90 percent distribution test since it would have only distributed 80 percent of the adjusted figure. Alternatively, if the section 856(b)(2)(C) deduction were $9,000,000, the distribution test would have been satisfied. For purposes of determining how much must be distributed to assure compliance with this 90 percent distribution test, the trust should take the position that any doubtful income item is income and any doubtful deduction item is not allowable. The reason for this approach (which at first blush appears almost disloyal) is that an agent, upon a subsequent audit, will not be concerned with the fact that a trust believed that the 90 percent test was satisfied. If, because of additional income inclusions or deduction disallowances on audit, 90 percent was not in fact distributed, the trust is disqualified. This disqualification occurs despite the fact that the test may be failed by an insignificant amount.

96. Real estate investment trust taxable income of $1,000,000 (§ 857(b)(2)), increased by $4,000,000 (the dividends paid deduction of § 857(b)(2)(C)) is $5,000,000.

97. Real estate investment trust taxable income of $1,000,000 (§ 857(b)(2)), increased by $9,000,000 (the dividends paid deduction of § 857(b)(2)(C)) is $10,000,000.

98. The problem can be simply illustrated. Assume a trust with gross income (all ordinary income) of $10,000,000 and deductions (other than the dividends paid deduction) of $8,000,000. The trust's taxable income for purposes of 90 % distribution test in $2,000,000 out of which $1,800,000 must be distributed. If the trust adheres literally to the requirement and distributes $1,800,000 it has met the test - at least for the time being. Assume further that on a subsequent audit the useful life for a particular item of depreciable property is
A partially effective safety valve is created by section 858. Due to the difficulty of accurately determining taxable income on the last day of the taxable year, the Code allows a trust to elect to have certain dividends paid after the close of the year treated as if paid during the taxable year in question. This "spill-over" election is permitted if the trust (1) declares the dividend prior to the time it must file its return for the taxable year and (2) in fact distributes such dividend within twelve months after the end of that taxable year and not later than the date of payment of its first regular quarterly dividend made after declaration of the "spill-over" dividend. The effect of this section is to permit the trust to purchase a limited amount of insurance by declaring a "spill-over" dividend, thereby creating a cushion against the possibilities of disqualification inherent in subsequent audit adjustments.

C. Income Taxation of the Real Estate Investment Trust

If a trust has satisfied both the definitional tests of section 856 and the distribution requirement of section 857(a)(1), it will achieve the "pass-through" or "conduit" treatment intended by the Congress. The trust will be taxed as a corporation on the undistributed portion of its real estate investment taxable income. In addition, the trust is subject to a capital gains tax on the undistributed excess of net long-term capital gains over net short-term capital losses. With respect to the treatment afforded distributed capital gains, it is important to realize that this result does

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increased by one year from four to five years and that the deduction taken was $1,000. In fact it should have been $800. The consequence is that taxable income is increased by $200 and the trust fails the test and is disqualified on the basis of this $180 under-distribution.

99. Under § 856(a)(1), this would include the period of any extension granted for the filing of that return.

100. For a recent discussion of certain proposals of the American Bar Association and the National Association of Real Estate Investment Trusts relating to this problem, see Carroll, Tax Policy for the Real Estate Investment Trusts, 28 TAX L. REV. 299, 315-19 (1973).

101. The trust, once it is qualified, must affirmatively elect the benefits of the REIT provisions of the Code. The election is made by computing its taxable income on its return in accordance with § 857. Once the election is made, it is irrevocable for the year involved and all succeeding taxable years. INT. REV. CODE OF 1954, § 856(c)(1), Treas. Reg. § 1.856-2(b) (1962). To maintain qualified status, the trust must also meet certain record keeping requirements relating to the actual ownership of its shares. INT. REV. CODE OF 1954, § 857(a)(2), Treas. Reg. § 1.857-7 (1962).

102. INT. REV. CODE OF 1954, § 857(b)(1); INT. REV. CODE OF 1954, § 11. In order to satisfy the 90% distribution requirement, this will never exceed 10% of taxable income (excluding capital gains).

not automatically accompany the distribution. The trust must affirmatively designate it as a capital gain dividend in a written notice sent to its shareholders.\textsuperscript{104}

\section*{D. Taxation of Shareholders of Real Estate Investment Trusts}

Once a trust has qualified and elected REIT treatment the shareholders are taxed as follows:\textsuperscript{105}

(1) to the extent of the trust's earnings and profits,\textsuperscript{106} REIT ordinary income distributions to shareholders are ordinary dividends;

(2) capital gains distributions retain their character and are treated as gains from the sale of capital assets held for \textit{more} than six months;

(3) the $100 dividend received exclusion\textsuperscript{107} is not available to individual shareholders; and

(4) the 85 per cent dividend received deduction\textsuperscript{108} is not available to corporate shareholders.

By this method, the object of treating the shareholders of the trust in substantially the same way as direct owners of real estate is accomplished.\textsuperscript{109}

\section*{III. Conclusion}

Although part of the Code for almost thirteen years, the full meaning of each of the provisions of sections 856 - 858 is far from totally revealed. Counsel to a trust must necessarily rely on the general outline furnished by the Code and regulations. Whatever detail has been added by published rulings does not even come close to filling in the blanks. Consequently, much of what becomes part of a REIT's operating blueprint results from a decision to avoid the risk of disqualification, despite the inevitable loss of

\textsuperscript{104} INT. REV. CODE OF 1954, § 857(b)(3)(C), Treas. Reg. § 1.857-4(e) (1962). This notice must be mailed within 20 days after the end of the trust's taxable year.


\textsuperscript{106} Treas. Reg. § 1.857-4(a) (1962). The earnings and profits of a qualified and electing REIT are computed somewhat differently from that of an ordinary corporation. Any deduction not permitted in reaching real estate investment trust taxable income is also barred in computing current earnings and profits. INT. REV. CODE OF 1954, § 857(d). For example, if a trust had a net capital loss during a particular year, that loss would not be taken into account and hence would not reduce earnings and profits.

\textsuperscript{107} INT. REV. CODE OF 1954, § 857(c).

\textsuperscript{108} Id.

\textsuperscript{109} In substance, this pass-through result extends to tax preference items of the trust. INT. REV. CODE OF 1954, § 58(f).
potentially successful investment opportunities. Hopefully the Treasury will see fit, in the not too distant future, to develop and publish its solutions to at least some of the many unanswered questions.