New Internal Revenue Code Treatment of Real Estate Investment Trusts and Its Application Under New York Law

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Subchapter "M" — Part II

Subchapter M of the Internal Revenue Code, which provides for the "conduit" or "pass through" tax treatment of regulated investment companies (mutual funds), was recently amended to extend substantially the same favorable tax treatment to qualifying real estate investment trusts. The newly favored organization must be an unincorporated trust or an unincorporated association, managed by trustees, which would otherwise be taxed as a corporation, with a diversity of ownership, passively but primarily engaged in and deriving most of its income from real estate investments of a non-speculative nature. If an organization of this sort conforms to the statutory requirements for a qualifying trust and if it distributes ninety per cent or more of its income to its shareholders or beneficiaries, it will be taxed only on its retained earnings. Its distributed income will be taxed in the hands of the recipients, in most instances, as if it had not passed through the trust.  

Shortly after the enactment of these new provisions, a serious question was raised concerning the availability of the business trust form of organization under the New York statutes as they then existed. Clarifying amendments to the statutes will be discussed after a general treatment of the new tax provisions.

Unincorporated Form

To qualify under the new statute the trust must be "an unincorporated trust or an unincorporated association," and it must be managed by "trustees." The proposed regulations indicate that these trustees must hold legal title to the trust property, and must have complete control over the trust affairs.

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3 See Roberts, Feder & Alpert, supra note 2.
4 CODE § 856(a).
5 CODE § 856(a) (1).
6 Proposed Treas. Reg. § 1.856-1(d) (1), 26 Fed. Reg. 603 (1961) (hereinafter cited as Proposed Regs.). These proposed regulations also make clear that the mere existence of a fiduciary relationship between nominal trustees and shareholders will not suffice to fulfill the "managed by trustees" requirement. Ibid.
lations specifically exclude limited partnerships from the advantages of the amendment, because a partner thereof is not considered a trustee for purposes of the section. The reason for the exclusion of corporations from the favored status does not appear in the legislative materials surrounding the enactment. However, in the new amendment there is a pervasive attempt to limit the trust's activity to "passive investment activity," since the Committee on Ways and Means believed that "any real estate trust engaging in active business operations should continue to be subject to the corporate tax. . ." Nevertheless, it seems unfortunate that corporations are necessarily excluded from qualifying, since that form of business could as well be used for passive investment purposes and is more adapted to the type of business involved (i.e., large scale solicitation of shareholders in an investment company). Surely, allowing qualified trusts to be incorporated would not soil the passive character which the remainder of the statute has ordained for them, and it would avoid the problems of local laws concerning the trust form of business in various states.

An additional qualification is that the trust must be one which would "but for the provisions of this part" be taxed as a corporation. This requirement further beclouds the reason for excluding corporations, since the trust is, in effect, ordered to operate substantially the same as a corporation although it is forbidden to incorporate. The Kintner Regulations indicate that a trust will be taxed as a corporation if it has such a preponderance of corporate characteristics that it more nearly resembles a corporation than a trust. These corporate characteristics are: (1) associates, (2) an

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7 Ibid.
9 H. R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960). This committee language and the obvious omission of corporations from the qualifying types of organizations may indicate an attempt to placate any Presidential fears which were in evidence in a 1956 veto message on a similar bill: "It is by no means clear how far a new provision of this sort might be applied. Though intended to be applicable only to a small number of trusts, it could, and might well become available to many real estate companies which were originally organized and have always carried on their activities as fully taxable corporations." See Channing, *Federal Taxation of the Income of Real Estate Investment Companies*, 36 Taxes 502, 512 n.28 (1958).
10 Texas, for instance, has held the beneficiaries of business trusts liable to creditors as partners. See Thompson v. Schmitt, 115 Tex. 53, 274 S.W. 554 (1925). For a similar Florida view, see Willey v. Hoggson Corp., 90 Fla. 343, 106 So. 408 (1925). At the time of the enactment of the new tax provision, New York statutes were not considered too favorable for business trusts, but these questionable sections have been amended and will be discussed infra.
11 Code § 856(a) (3).
12 Treas. Reg. § 301.7701-2 (1961). See also Treas. Reg. § 301.7701-4(b)(c) (1961) which includes business trusts in "associations" which will be taxed as corporations.
objective to carry on a business and divide the gains therefrom, 
(3) continuity of life, (4) centralization of management, (5) liabil-
ity for corporate debts limited to corporate property, and (6) 
free transferability of interests. 13

**Diversification of Ownership**

The beneficial ownership of a qualified trust must be shared 
by one hundred or more persons 14 for at least 335 days of a twelve-
month taxable year or a proportionate part of a shorter period. 15 
A further subsection provides that, apart from income, the qualifying 
trust may not be a personal holding company 16 (fifty per cent of the 
trust’s stock may not be owned by five people or less for the last 
half of the trust’s taxable year). The proposed regulations specifi-
cally provide that direct or indirect ownership, as provided for in 
Section 544 of the Code, shall apply in determining whether or 
not a trust is a personal holding company. 17

An interesting problem arises in the indirect ownership area 
when one realizes that a mere eleven or more parties in interest 
could divide their shares nominally among one hundred or more 
relatives or trusts with themselves as beneficiaries and still qualify 
for the special tax treatment, while all the distributions of the real 
estate investment trust would actually be accruing to the eleven 
parties in interest. It would seem that this was not the intention 
of the drafters and this situation may deserve attention in the 
future.

**Source of Income and Required Assets**

Ninety per cent of a qualifying trust’s income must come from 
generally prescribed sources. At least seventy-five per cent must 
be derived from real property (i.e., income from rents, interest on 
obligations secured by mortgages on real property, gains from the 
sale of real property or mortgages, income from other real estate 
investment trusts, and abatements or refunds on property taxes). 
An additional fifteen per cent of the trust income must come from 
the same source or from dividends, interest, or gains from the sale

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13 Treas. Reg. § 301.7701-2 (1961). These regulations basically follow the 
14 Code § 856(a) (5). Since an offer of shares in the trust to one hundred 
or more persons would likely be a public offering, these offers may be subject 
to the federal and state securities laws and the prospectuses should be pre-
pared with this in mind. See 7 CCH 1961 STAND. FED. TAX REP. § 8791 at 
73493; Baldinger, Real Estate Investment Trusts, 27 J.B.A.D.C. 584, 660-61 
(1960).
15 Code § 856(b).
16 Code § 856(a) (6).
17 ProposedRegs. § 1.856-1(d) (5).
of securities.\(^{18}\) No more than thirty per cent of the trust's income may come from gains on the sale of securities held for less than six months or real property held for less than four years.\(^{19}\)

The assets which a qualified trust may hold are similarly prescribed. At least seventy-five per cent of the value of its assets must be represented by real estate assets, cash and cash items (including receivables), and government securities.\(^{20}\) To help insure the passivity of the trust in its investment operations, Congress has provided that it may "not hold any property primarily for sale to customers in the ordinary course of its trade or business."\(^{21}\) It has been pointed out that the new provision prohibits the mere holding of this "dealer" property and the trust need not necessarily sell it to be disqualified as a real estate investment trust.\(^{22}\) If the seventy-five per cent asset requirement is fulfilled, the further requirement that less than twenty-five per cent of its assets be represented by securities\(^{23}\) (other than those included in the seventy-five per cent requirement) will automatically be met. To avoid concentration of investment and, again, to insure passivity, investments in any one issuer of the latter group of securities may not exceed five per cent of the trust's total assets or ten per cent of the issuer's outstanding voting securities.\(^{24}\) These asset requirements must be met at the close of each quarter of the taxable year.\(^{25}\) Mere increase in market value of the trust assets will not operate to disqualify a trust.\(^{26}\) The failure to meet the asset requirements must exist immediately after acquiring property, and must remain uncorrected for thirty days after the close of the quarter for the trust to be disqualified.\(^{27}\) The section does not expressly provide for the effect of a change in asset apportionment due to a disposition

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\(^{18}\) **Code** § 856(c)(2)(3).

\(^{19}\) **Code** § 856(c)(4).

\(^{20}\) **Code** § 856(c)(5)(A). The term "value" is defined in §856(c)(6)(A).

\(^{21}\) **Code** § 856(a)(4).

\(^{22}\) Roberts, Feder & Alpert, *Congress Approves Real Estate Investment Trust; Extracting Rules Made*, 13 J. Taxation 194 (1960). Several suggestions made by the authors in this article concerning asset requirements are well taken (e.g., "the value of the trust's 'total assets' . . . [should be determined] without diminution for mortgages thereon . . ."). *Id.* at 195.

\(^{23}\) **Code** § 856(c)(5).

\(^{24}\) **Code** § 856(c)(5)(B).

\(^{25}\) **Code** § 856(c)(5).


\(^{27}\) Thus, for example, if a qualifying trust had the proper asset apportionment in one quarter, but in the following quarter an increase in market value of their non-real estate securities made these securities worth more than 25% of the value of the trust's total assets, no disqualification would occur, and no reapportionment would be necessary. But as soon as the trust makes an acquisition of another asset of any type, the trust must then completely readjust its asset apportionment to meet the requirements. See Proposed Regs. § 1.856-2(d)(4), example 4.
of property during any quarter, but presumably it may cause a disqualification.

The term "real estate assets" is defined in the new sections as including real property or interests in real property, interests in mortgages on real property, and shares in other qualifying real estate investment trusts.28 The proposed regulations also impute proportionate ownership of partnership property (including "dealer" property) to trusts holding partnership interests.29

In describing what rents from real property will be used in the computation of the seventy-five per cent requirement,30 the drafters again directed their attention to preventing active real estate operators from benefitting from the amendment. Rents may not depend on the income of the property, but rents based on a percentage of receipts or sales may be included;31 rents will not be included if the trust manages the property or supplies services for its tenants.32 The property must be managed by independent contractors33 who do not own thirty-five per cent or more of the shares of the trust,34 nor may the trust be more than a ten per cent owner of the voting stock of a corporate tenant or the assets of an unincorporated tenant.35 If any of these prohibited situations exists, the rents derived therefrom will not be considered "from real property" for purposes of the statute.

Non-Speculative Investments

Entrepreneurs expecting to speculate with "trust" funds will find themselves quickly disqualified from real estate investment trust tax treatment if their speculation is too profitable. A qualifying trust must not derive more than thirty per cent of its income from gains on the sale of securities held for less than six months or real property held for less than four years.36

Taxation of the Trust

If a trust fulfills the requirements of sections 856-57 and elects at the end of a taxable year to be taxed as a real estate in-

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28 CODE § 856(c) (6) (B).
29 Proposed Regs. § 1.856-3(g).
30 CODE § 856(d).
31 CODE § 856(d) (1).
32 CODE § 856(d) (3). The proposed regulations also prohibit trustees from being an employee of, or having an interest in, an independent contractor managing any of the trust's property. Proposed Regs. § 1.856-1(d) (1).
33 Ibid.
34 CODE § 856(d) (3) (A).
35 CODE § 856(d) (2).
36 CODE § 856(c) (4).
vestment trust,\textsuperscript{37} it will receive a dividends paid deduction in computing its tax.\textsuperscript{38} The real estate trust's taxable income is arrived at by computing its normal taxable income as if it were a corporation.\textsuperscript{39} Then the net long term capital gain is excluded.\textsuperscript{40} If the dividends distributed (excluding capital gains dividends) equal or exceed ninety per cent of the remainder, they are deducted from the remainder.\textsuperscript{41} This gives the real estate investment trust taxable income which is taxed at the applicable corporate rate.\textsuperscript{42} Added to this tax is a twenty-five per cent tax on the excess of the net capital gain over the capital gains dividends paid.\textsuperscript{43}

The net operating loss deduction, as well as deductions for dividends received, are not allowed to real estate investment trusts, and the taxable income is computed without regard to any change in the annual accounting period.\textsuperscript{44} It would appear from the statute that capital losses not absorbed by capital gains in the same year will be lost to the trust in succeeding years.\textsuperscript{46}

\textbf{Taxation of the Shareholder}

Ordinary taxable income which is distributed to the shareholder is taxable to the recipients as ordinary income.\textsuperscript{46} Since all capital gains dividends must be treated as long term capital gains, any loss on the sale of trust shares held for less than thirty-one days must also be treated as a loss from the sale or exchange of capital assets held for more than six months.\textsuperscript{47}

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{37} CODE § 856(c) (1). This election must be made at the time of filing the trust's tax return and is irrevocable in all succeeding years according to Proposed Regs. § 1.856-2(b). Although it is irrevocable, the trust may always disqualify itself by reappportioning its assets or not distributing 90% of its income and cause itself to be taxed as a corporation again. Hence, the irrevocability would seem rather illusory.
\item \textsuperscript{38} CODE § 857(b) (2)(C). The ordinary dividends paid will be deducted from ordinary taxable income (if they exceed 90% of this income) in computing the normal tax and surtax. Then the capital gains dividends paid will be deducted from the capital gains in computing the capital gains tax. See CODE § 857.
\item \textsuperscript{39} CODE § 857(b) (1). However, the taxable income and the dividends paid deduction (excluding capital gains) shall be reduced by the deduction provided for by § 242 (relating to partially tax-exempt interest). \textit{Ibid}.
\item \textsuperscript{40} CODE § 857(b) (2).
\item \textsuperscript{41} CODE § 857(a) (1), (b) (2)(C).
\item \textsuperscript{42} CODE § 857(b) (1).
\item \textsuperscript{43} CODE § 857(b) (3).
\item \textsuperscript{44} CODE § 857(b) (2).
\item \textsuperscript{45} See CODE § 857(d).
\item \textsuperscript{46} Proposed Regs. § 1.857-4(a).
\item \textsuperscript{47} CODE § 857(b) (4). A shareholder may still acquire short-term capital losses if needed by holding the shares for more than 31 days but less than six months.
\end{enumerate}
\end{footnotesize}
Distributions are not considered dividends as to the shareholder and are not eligible for the dividends received credit, exclusion or deduction (for corporations).\(^{48}\) The distributed capital gains of the trust are taxed to the recipients as long term capital gains.\(^{49}\) Dividends received are included in the shareholder's income for the year in which they are received,\(^{50}\) despite the fact that the trust may consider them paid in the previous year.\(^{51}\)

Thus we have the statutory picture of a real estate investment trust for income tax purposes. The utilization of the amendment, its drafters hope, will "encourage the availability of funds for real estate purposes,"\(^{52}\) and perhaps alleviate the "shortage of private capital and mortgage money for individual homes, apartment houses, office buildings, factories and hotels."\(^{53}\)

**New York Developments**

Until recently, questions had been raised whether New York statutes permitted the establishment or existence of a qualifying real estate investment trust in that jurisdiction.\(^{54}\) Specifically: (1) Section 96 of the New York Real Property Law, which enumerates the only valid purposes for which an express trust may be created, did not include real estate investment trusts among those purposes; (2) the free alienation of a beneficiary's interest in trusts to receive income and apply it to the use of any person is prohibited by statute;\(^{55}\) (3) spendthrift trusts are within the scope of the New York Rule Against Perpetuities.\(^{56}\)

The legislature has now modified these sections to enable the creation of real estate investment trusts in New York.\(^{57}\) Section

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\(^{48}\) Code § 857(c).

\(^{49}\) Code § 857(b)(3)(B).

\(^{50}\) Code § 889(b).

\(^{51}\) Code § 858(a) makes it possible for the trust to declare a dividend before the date for filing its return for the taxable year, and, although the dividend is not distributed until the following year, deduct it on the return for the year in which it was declared.

\(^{52}\) 106 Cong. Rec. 13947 (daily ed. June 29, 1960). The Committee on Ways and Means pointed out that the bill also had the approval of the Treasury Department. Although the bill will involve a three to seven million dollar tax loss, it was felt that "if in the long run the bill substantially stimulates real estate investment activity, there would be off-setting revenue gains." *Ibid.*


\(^{54}\) See, e.g., 2 *Bogert, Trusts and Trustees* § 304 (1953); Roberts, Feder & Alpert, *Congress Approves Real Estate Investment Trust; Exacting Rules Made*, 13 J. Taxation 194, 198 (1960).

\(^{55}\) N.Y. Pers. Prop. Law § 15; N.Y. Real Prop. Law § 103 (prior to the amendments of these statutes of April 6, 1961).

\(^{56}\) N.Y. Pers. Prop. Law § 11; N.Y. Real Prop. Law § 42.

\(^{57}\) See N.Y. Real Prop. Law §§ 96(7), 42(d) 103(1); N.Y. Pers. Prop. Law §§ 11(c), 15(1) (effective April 6, 1961).
96 has been extended so that real estate investment trusts are now the seventh valid purpose for which an express trust may be created in New York. The Rule Against Perpetuities has been altered to exclude real estate investment trusts from its application. Finally, Section 15 of the New York Personal Property Law and Section 103 of the New York Real Property law make beneficial interests in a business trust freely alienable.

Although this New York legislation finally settles the New York problem as to real estate investment trusts, it did not come unheralded, nor does it represent a significant change in policy. Case law, statutes and the literature prior to these amendments indicated that the business trust was never intended to come within the purview of the restrictive statutes concerning trusts. The New York General Association Law provided for the registration of business trusts "doing business in New York" with the Department of State. In addition, the New York Tax Law,

58 N.Y. REAL PROP. LAW § 96. "An express trust may be created for one or more of the following purposes: . . .

(7) To purchase, acquire, hold, improve, lease, sell or mortgage or otherwise encumber real property or real and personal property or interests in real or personal property, to receive the income, interest, rents and profits thereof, and to reinvest them or distribute them, in accordance with the written instrument creating such trust, to the holders of beneficial interests in such trust, which beneficial interests shall be evidenced by transferable certificates or other written instruments which shall be transferable by the holders thereof in accordance with the written instrument creating such trust."

Ibid.

59 N.Y. REAL PROP. LAW § 42(d). "Trust with transferable certificates. A trust, consisting in whole or in part of real property, created under the provisions of subdivision seven of section ninety-six of this chapter shall not be deemed to be invalid as violating any existing laws against perpetuities or suspension of the power of alienation; but such trust may continue for such time as may be necessary to accomplish the purposes for which it may be created, provided, that the written instrument creating such trust provides that such trust may be terminated at any time by act of the trustees or by affirmative vote of a specified percentage in interest of the beneficiaries thereunder." See also N.Y. PERS. PROP. LAW § 11(c) (applies the principle of § 42(d) to personalty).

60 N.Y. PERS. PROP. LAW § 15(1): "The right of the beneficiary to enforce the performance of a trust to receive the income of personal property, and to apply it to the use of any person, can not be transferred by assignment or otherwise. But the right and interest of the beneficiary of any other trust in personal property, including the beneficiary of a trust in personal property . . . pursuant to subdivision seven of section ninety-six of the real property law . . . may be transferred." N.Y. REAL PROP. LAW § 103(1): "the right and interest of the beneficiary . . . of a trust under subdivision . . . seven of section ninety-six of this chapter, may be transferred."

61 See N.Y. LAW REV. COMM., 249, 274 (1937).

62 N.Y. GEN. ASS'NS LAW § 18. See also § 2, which excludes a business trust from a stock association, and defines business trusts as "any association
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which levies the corporate franchise and license taxes, alluded to business trusts as being covered by those statutes.\(^{63}\) This apparently indicates that the legislature had contemplated the existence of business trusts in New York for some time.

Although several Court of Appeals cases involving business trusts have been decided, the validity of the business trust has never been in issue.\(^{64}\) The court has held that where the trustees are given full power to buy and sell, to invest and reinvest the trust property (as would be the case in real estate investment trusts), there would be no objection under the Rule Against Perpetuities, since the absolute ownership and power to alienate the trust property is vested in the trustees.\(^{65}\) It is felt that the beneficial interests of the shareholders of the trust (represented by certificates) would also be freely alienable when so stipulated in the trust agreement, since these beneficiaries would be settlors of the trust \(^{66}\) (or assignees of settlors) to whom the sections restricting alienation of interests in "spendthrift trusts" would not apply.\(^{67}\)

In *Byrnes v. Chase National Bank*,\(^{68}\) the Court recognized the exemption of the members of a syndicate from the personal liability for the debts of the syndicate beyond the extent of their contributions to the trust, on the reasoning that the syndicate agreement

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63 See N.Y. Tax Law § 181, which provides that foreign corporations (which term includes "any business conducted by a trustee or trustees wherein interest of ownership is evidenced by certificate or other written instrument") must pay a license fee for doing business in this state, and § 182 which levies a franchise tax on real estate corporations which expressly include "any business conducted by a trustee or trustees wherein interest or ownership is evidenced by certificates or other written instruments."


66 See N.Y. Pers. Prop. Law § 15 and N.Y. Real Prop. Law § 103 before the recent amendments to these sections.

67 Vanderbilt v. Balsan, 190 Misc. 824, 77 N.Y.S.2d 403 (Sup. Ct. 1948). "While section 15 of the Personal Property Law prohibits a beneficiary from transferring the right to receive the income of personal property, this inhibition is inapplicable where the beneficiary is the settlor of the trust." *Id.* at 834-35, 77 N.Y.S.2d at 413; Newton v. Hunt, 134 App. Div. 325, 330, 119 N.Y. Supp. 3, 7-9 (1st Dep't 1909), aff'd, 201 N.Y. 599, 95 N.E. 1134 (1911). See also Baker v. Stern, 194 Wis. 233, 216 N.W. 147 (1927) which included business trusts within this exception.

68 *Supra* note 64.
placing control of the syndicate business completely in the trustees
had created a business trust rather than a joint adventure or
partnership. The Court of Appeals' language in Brown v. Bedell\(^69\)
strongly indicates the acceptance of the business trust in New York
without referring to any statutory restrictions. While distinguishing
the organization there involved from a business trust, the Court
did state that “business trusts may be utilized as substitutes for
corporations”\(^70\) and that this device is “sustained by the great weight
of authority.”\(^71\)

The New York Law Revision Commission has made a cautious
but significant contribution to this pattern of business trust treat-
ment. It posed the question:

Do the statutory provisions in New York specifying the legitimate purposes
of a trust or the statutory provisions relating to perpetuities exclude the
possibility of business trusts in this state?\(^72\)

Its answer:

It may fairly be said that these statutory provisions do not in and of them-
selves exclude the possibility of business trusts.\(^73\)

Thus, the infrequent occasions on which the validity of business
trusts has been open to question in New York State have been
characterized by the tacit acceptance of the business trust by the
state lawmakers. It is submitted that the 1961 amendments to the
New York laws concerning real estate investment trusts are ap-
propriate and timely in the wake of the new Internal Revenue Code
provisions.

Conclusion

The new tax treatment of real estate investment trusts has long
been awaited by those organizations of this type already in existence,
particularly in Massachusetts.\(^74\) It will almost double the amount
of their distributable income, thereby stimulating investment in their
shares. It is felt that it will open up in other areas, including

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\(^{69}\) 263 N.Y. 177, 188 N.E. 641 (1934).
\(^{70}\) Id. at 186, 188 N.E. at 643.
\(^{71}\) Ibid.
\(^{72}\) N.Y. LAW REVISION COMM'N REP., 249, 273-74 (1937).
\(^{73}\) Ibid.
\(^{74}\) See Channing, Federal Taxation of the Income of Real Estate Investment Companies 36 TAXES 502 (1958). Many Massachusetts real estate investment companies had been listed on the Boston Stock Exchange for many years, and undoubtedly did much to encourage this new tax provision.
New York, new avenues of investment for the comparatively small investor, thereby fulfilling congressional hopes for more available money for real estate development. The same favorable tax treatment has undoubtedly been a leading reason for the phenomenal success of "mutual funds" in recent years, and this extension of congressional munificence may well be the beginning of a sequel to the mutual funds success story entitled "Subchapter M—Part II."