A COMPARATIVE ANALYSIS OF CONTEMPORARY
REAL ESTATE INVESTMENT TRUST
FORMS AND OPERATIONAL POLICIES

A Thesis
Presented in Partial Fulfillment of the Requirements
for the Degree Master of Business Administration

by
Frank William Zalar, B.S.B.A.
The Ohio State University
1968

Approved by

[Signature]
Adviser
Department of Business Organization
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>CHAPTER</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>Objective of the Study</td>
<td>2</td>
</tr>
<tr>
<td>Justification</td>
<td>2</td>
</tr>
<tr>
<td>Scope</td>
<td>3</td>
</tr>
<tr>
<td>Methodology and Source of Information</td>
<td>4</td>
</tr>
<tr>
<td>Limitations</td>
<td>5</td>
</tr>
<tr>
<td>II. A HISTORY AND LEGAL DESCRIPTION OF REAL ESTATE INVESTMENT</td>
<td></td>
</tr>
<tr>
<td>TRUSTS</td>
<td>6</td>
</tr>
<tr>
<td>Congressional Purpose in Enactment of Trust Regulations</td>
<td>7</td>
</tr>
<tr>
<td>Legal Requirements for Qualification as a Real Estate Investment</td>
<td>9</td>
</tr>
<tr>
<td>Investment Trust</td>
<td>10</td>
</tr>
<tr>
<td>Definition of a Real Estate Investment Trust</td>
<td>10</td>
</tr>
<tr>
<td>Organizational Requirements</td>
<td>11</td>
</tr>
<tr>
<td>Ownership Requirements</td>
<td>11</td>
</tr>
<tr>
<td>Trustee Administration Requirement</td>
<td>12</td>
</tr>
<tr>
<td>Purpose and Structure Requirements</td>
<td>13</td>
</tr>
<tr>
<td>Income Requirements</td>
<td>14</td>
</tr>
<tr>
<td>The Ninety Per Cent Test</td>
<td>14</td>
</tr>
<tr>
<td>The Seventy-five Per Cent Test</td>
<td>15</td>
</tr>
<tr>
<td>The Thirty Per Cent Test</td>
<td>15</td>
</tr>
<tr>
<td>General</td>
<td>16</td>
</tr>
<tr>
<td>Investment Requirements</td>
<td>16</td>
</tr>
<tr>
<td>Real Estate Asset Test</td>
<td>16</td>
</tr>
<tr>
<td>Non-Real Estate Securities Test</td>
<td>17</td>
</tr>
<tr>
<td>CHAPTER</td>
<td>PAGE</td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>Determination of Status</td>
<td>17</td>
</tr>
<tr>
<td>Miscellaneous Requirements</td>
<td>18</td>
</tr>
<tr>
<td>Independent Contractor</td>
<td>18</td>
</tr>
<tr>
<td>Election to Be Taxed as a Real Estate Trust</td>
<td>19</td>
</tr>
<tr>
<td>III. A COMPARISON OF REAL ESTATE INVESTMENT VEHICLES</td>
<td>20</td>
</tr>
<tr>
<td>Real Estate Syndicates</td>
<td>20</td>
</tr>
<tr>
<td>Single Proprietorship</td>
<td>21</td>
</tr>
<tr>
<td>Tenancy in Common, Joint Tenancy, and Tenancy by Entirety</td>
<td>22</td>
</tr>
<tr>
<td>Real Estate Partnership</td>
<td>23</td>
</tr>
<tr>
<td>Real Estate General Partnership</td>
<td>23</td>
</tr>
<tr>
<td>Real Estate Limited Partnership</td>
<td>24</td>
</tr>
<tr>
<td>Real Estate Corporations</td>
<td>25</td>
</tr>
<tr>
<td>Real Estate Investment Trusts</td>
<td>27</td>
</tr>
<tr>
<td>Taxation of Real Estate Investment Trusts</td>
<td>27</td>
</tr>
<tr>
<td>Taxation of Real Estate Investment Trust Beneficiaries</td>
<td>29</td>
</tr>
<tr>
<td>IV. KINDS OF TRUSTS</td>
<td>31</td>
</tr>
<tr>
<td>&quot;Blank Check&quot; Trusts</td>
<td>31</td>
</tr>
<tr>
<td>Exchange Trusts</td>
<td>33</td>
</tr>
<tr>
<td>Purchase Trusts</td>
<td>34</td>
</tr>
<tr>
<td>Mixed Trusts</td>
<td>36</td>
</tr>
<tr>
<td>Existing Trusts</td>
<td>36</td>
</tr>
<tr>
<td>Mortgage Trusts</td>
<td>37</td>
</tr>
<tr>
<td>CHAPTER</td>
<td>PAGE</td>
</tr>
<tr>
<td>---------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>V. OPERATIONAL POLICIES</td>
<td>45</td>
</tr>
<tr>
<td>Diversification</td>
<td>49</td>
</tr>
<tr>
<td>Debt Policy</td>
<td>49</td>
</tr>
<tr>
<td>Depreciation</td>
<td>53</td>
</tr>
<tr>
<td>Dividends</td>
<td>56</td>
</tr>
<tr>
<td>VI. CONCLUSION AND SUMMARY</td>
<td>63</td>
</tr>
<tr>
<td>Conclusion</td>
<td>63</td>
</tr>
<tr>
<td>Legislative Deficiencies</td>
<td>63</td>
</tr>
<tr>
<td>Corporate Status</td>
<td>63</td>
</tr>
<tr>
<td>Trustee Management</td>
<td>64</td>
</tr>
<tr>
<td>Disqualification</td>
<td>65</td>
</tr>
<tr>
<td>Operational Deficiencies</td>
<td>66</td>
</tr>
<tr>
<td>Diversification</td>
<td>66</td>
</tr>
<tr>
<td>Profitability</td>
<td>68</td>
</tr>
<tr>
<td>Summary</td>
<td>70</td>
</tr>
<tr>
<td>BIBLIOGRAPHY</td>
<td>72</td>
</tr>
</tbody>
</table>
LIST OF TABLES

<table>
<thead>
<tr>
<th>TABLE</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Assets and Debt of Selected Mortgage Real Estate Investment Trusts</td>
<td>39</td>
</tr>
<tr>
<td>II. Assets of Selected &quot;Combination&quot; Real Estate Investment Trusts</td>
<td>44</td>
</tr>
<tr>
<td>III. A Comparison of Size and Investments of Selected Real Estate Investment Trusts</td>
<td>48</td>
</tr>
<tr>
<td>IV. Debt Position of Selected Real Estate Investment Trusts</td>
<td>52</td>
</tr>
<tr>
<td>V. Cash Flows and Cash Distributions of Selected Real Estate Investment Trusts</td>
<td>57</td>
</tr>
<tr>
<td>VI. Distributions Per Share of Selected Real Estate Investment Trusts</td>
<td>59</td>
</tr>
<tr>
<td>VII. Distributions Paid by Selected Real Estate Investment Trusts</td>
<td>61</td>
</tr>
</tbody>
</table>
# LIST OF FIGURES

<table>
<thead>
<tr>
<th>FIGURE</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Interest Payments and Cash Demands</td>
<td>50</td>
</tr>
<tr>
<td>II. Straight-line Depreciation and Cash Demands</td>
<td>54</td>
</tr>
<tr>
<td>III. Accelerated Depreciation and Cash Demands</td>
<td>55</td>
</tr>
</tbody>
</table>
CHAPTER I

INTRODUCTION

On September 14, 1960, President Eisenhower signed Public Law 86-779. Known as the Omnibus Law, the statute covered topics ranging from "Expenditures by Farmers for Fertilizer" to "The Pension Fund, Plumbers's Local Union Numbered 775." Section 10 of the Law amended Subchapter M of the Internal Revenue Code of 1954 by adding Part II entitled "Real Estate Investment Trusts." 1

This small section of such an all-encompassing law has become one of the most heralded changes in the Internal Revenue Code and could very well become the most important piece of tax legislation enacted in recent years.

Still a relatively young investment vehicle, real estate investment trusts2 have found growing favor in the eyes of investors. The future of this new intermediary has been described in these words:

As a vehicle for group investment the real estate investment trust could easily find as widespread acceptance as has the mutual fund. There is little doubt that real estate investment trusts will soon be in competition with the mutual funds for the investors' dollars and because of the tremendous tax advantages which can be obtained through real estate investment it is conceivable that their share of the

---


2 In this paper the terms "real estate investment trust," "R.E.I.T.," "real estate trust," "realty trusts," "trusts," and "REIT" refer to the same type of investment medium and will be used interchangeably. If any other form of trust is referred to, it will be properly noted and defined.
investment dollar may one day exceed that of the mutual fund.\(^3\)

**OBJECTIVE OF THE STUDY**

The purpose of this thesis is to present a comprehensive picture of real estate investment trusts. The study assembles and analyzes information on the R.E.I.T. as a legal entity, an investment intermediary, and as a functioning part of today's real estate market. Special emphasis is placed on an analysis and comparison of the make-up, performance, and operational policies of the various kinds of real estate trusts. This analysis attempts to make it possible for the reader to gain an insight into the newest of real estate investment vehicles.

**JUSTIFICATION**

The rationale behind enactment of the R.E.I.T. law was to give small investors the benefits available through pooling of funds, and to bring fresh capital into the real estate market.

Initially, the new law was quickly accepted by real estate investors and more than 50 trusts were registered with the S.E.C. in the two years immediately following passage of the statute.\(^4\) In 1962 the investment market in general, and the real estate market in particular, 

---


suffered a setback. A number of real estate ventures failed and a few were found to be guilty of misconduct. Suffering from guilt-by-association, real estate trusts were looked upon with some question. As a result, little was accomplished in the way of research and analysis of realty trusts.

In a conversation with a securities broker of a national brokerage house this writer mentioned that he was considering the possibility of writing a thesis on real estate investment trusts. The broker unhesitatingly recommended that the subject be dropped. He stated that his firm did not give opinions on real estate trusts because not enough was known about them.

Likewise, a survey of literature in the real estate field shows that the R.E.I.T has either been neglected or not given justice. Most periodicals and books limit their presentation to one particular area of the trusts—usually a paraphrasing of the Internal Revenue Code and Treasury regulations.

What is needed, and what this thesis attempts to present, is a critical, comprehensive study of real estate investment trusts. This thesis will assemble, analyze, compare, and organize the piecemeal information available to present a study which can be of use to those interested in this real estate investment vehicle.

SCOPE

The first chapter introduces the study, setting forth the purpose, organization, methodology, sources of information, and limitations of the study.

Each of the next four chapters looks at real estate trusts from
a particular viewpoint. Chapter II presents an analysis of the R.E.I.T. as a legal entity. The first part of the chapter is devoted to an historical look at real estate trusts and a discussion of the reasons behind enactment of legislation creating trusts. The second half of the chapter presents a detailed analysis of the legal requirements which must be met to qualify for special tax treatment as a real estate investment trust.

Chapter III looks at trusts as investment vehicles. This chapter compares trusts with real estate syndicates and corporations on a number of bases with special emphasis being given to tax considerations.

Chapter IV presents a description of the various forms of real estate trusts which exist today. This is followed by a financial analysis of the performance of the major types of trusts.

Chapter V follows with a look at the different managerial policies regarding leverage, depreciation, growth, and profit distribution.

The third major section of this thesis, Chapter VI, is a summary and review of observations made in the study. This final chapter also indicates those areas where research has shown that further legislation may be needed.

METHODOLOGY AND SOURCES OF INFORMATION

The research in this thesis consists basically of a thorough examination of literature in the real estate investment field.

Real estate investment trusts, born in 1960, are a relatively new investment medium. Therefore, as noted before, the material written
about them is far from voluminous and, at best, only touches the subject. Periodical and text book treatment of trusts was found to be limited to specific areas of consideration. Various reporting services are excellent sources of information, as are the Internal Revenue Code of 1954 and the pertinent Treasury regulations.

This thesis is primarily concerned with analyzing and organizing the information in these sources and presenting it in a meaningful and enlightening form.

LIMITATIONS

The limitations in this study result from the nature and relative youth of the topic as well as from the limited amount of time and funds which can be devoted to the study.

Real estate investment trusts, as recognized by the tax law, had their beginning in late 1960. In the last five years only a limited amount of information has been written about them. This small amount of information—especially performance data—has limited research.
CHAPTER II

A HISTORY AND LEGAL DESCRIPTION OF

REAL ESTATE INVESTMENT TRUSTS

Public Law 86-779 did not create the concept of a real estate investment trust. Rather, it created a framework within which trusts could be organized to receive special tax consideration. This law prescribed the organizational, income, and investment requirements which must be met by a trust holding real estate if it wished to be taxed under the same favorable status accorded regulated investment companies.

The original form of real estate trust\(^5\) was set up in Massachusetts in the middle of the nineteenth century. At that time Massachusetts' corporations were not permitted to invest in real estate other than that which was necessary to carry out their business operations. A company could own its office and plant, but it could not hold unused real estate for investment purposes.

To meet this problem, Boston investors devised the real estate trust. Known as "Massachusetts Trusts," the associations issued transferable shares of beneficial interest as evidence of ownership of the trust. Actual title to the property was held by a Board of Trustees whose actions were governed by a Trust Indenture which was altered and amended by a vote of the holders of the beneficial shares.

---

\(^5\)Earlier trust forms did not necessarily have the same organizational structure as do present day real estate investment trusts which meet the Internal Revenue Code regulations.
As "Massachusetts Trusts" became more popular, their number grew until by the beginning of the Great Depression they were located in most of the big cities of the country. But this growth was quickly brought to a halt by a Supreme Court Decision in 1936 which held that real estate trusts—like other passive investment vehicles with corporate-like structure—were taxable as corporations.6 Later, as the corporation tax rate approached the 50 per cent level, many real estate trusts liquidated and sold their assets to tax-exempt organizations.

After the 1936 Supreme Court Decision, the strong security investment companies acted quickly and persuaded Congress to permit diversified investment companies to be exempt from corporate tax if they paid out 90 per cent of their net income each year. Unfortunately, the real estate trusts were disorganized at this time and were unable to secure similar tax privileges.

It was not until September, 1960, after years of effort by older trusts and others, that legislation was finally passed granting the same conduit tax treatment to R.E.I.T.s as was given to mutual funds.7

CONGRESSIONAL PURPOSE IN ENACTMENT
OF THE TRUST REGULATIONS

Your committee believes that the equality of tax treatment between the beneficiaries of real estate investment trusts and the shareholders of regulated


investment companies is desirable since in both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources.\(^8\)

In the preceding words the House of Representatives\(^9\) Ways and Means Committee has stated the basic rationale behind passage of the R.E.I.T. legislation. Congress has attempted to extend to trust beneficiaries the same treatment granted to regulated investment companies. That is, by removing taxation from distributed earnings, investors would get essentially the same tax treatment as if they had invested directly in real estate equities and mortgages. The Committee noted that similar tax treatment for R.E.I.T. beneficiaries and the shareholders of regulated investment companies was desirable because both methods involve pooling of funds whereby small investors can secure advantages normally available only to those with large resources.

...your committee believes it is also desirable to remove taxation to the extent possible as a factor in determining the relative size of investments in stocks and securities on one hand, and real estate equities and mortgages on the other.\(^9\)

After reviewing the state of the economy, the House Committee saw that there was a shortage of private capital for office buildings, apartments, factories, and other real estate development. It also recognized that the largest source of funds available for investment purposes was in the hands of small investors who had only a few dollars at a time to invest. The Committee felt that the new legislation would

---

\(^8\) House of Representatives' Report Number 2020, 86th Congress, 2nd Session (1960), p. 3.

\(^9\) Ibid, p. 4.
make these funds more available to the real estate market and reduce the tendency to finance real estate development through government guaranteed money and through special, tax favored groups such as life insurance companies and pension funds.

It is evident that Congress has undertaken to open large sources of new funds for the real estate market, and at the same time open new investment opportunities for investors with limited funds.

LEGAL REQUIREMENTS FOR QUALIFICATION AS A REAL ESTATE INVESTMENT TRUST\textsuperscript{10}

Although the tax law granting special tax consideration to "qualified" real estate investment trusts was signed by President Eisenhower in September of 1960, it was not until nineteen months later--April 26, 1962--that the final Treasury regulations were issued and promulgated. During the intervening months the tentative, proposed Treasury regulations which were issued were found to be highly restrictive and confusing, and had to be rewritten.

The remainder of this chapter presents a review of the requirements of the tax law and the Revenue Service regulations which must be met to qualify as a R.E.I.T. This analysis is based on current tax regulations as reflected in Treasury Department publications and in various income tax reporting services.

\textsuperscript{10}The references which follow are, unless otherwise indicated, to the Internal Revenue Code of 1954 (Code) and Treasury Department Regulations (Regs.).


**Definition of a Real Estate Investment Trust**

The term "real estate investment trust" means an unincorporated trust or unincorporated association which (1) meets the status conditions in section 856 (a) and paragraph (b) of this section, and (2) satisfies the gross income and asset diversification requirements under the limitations of section 856 (c) and section 1.856-2.\(^\text{11}\)

Simply stated, a real estate investment trust is an unincorporated trust or association which meets certain organizational, income, and investment requirements prescribed by the *Internal Revenue Code* and Treasury regulations.

A trust which meets the applicable requirements, elects to be taxed as a qualified R.E.I.T., and distributes 90 per cent or more of its net earnings each year, pays corporation income tax on only its undistributed earnings.

**Organizational Requirements**

To qualify as a "real estate investment trust" the *Internal Revenue Code* states that an unincorporated organization must be one:\(^\text{12}\)

1. Which is managed by one or more trustees,
2. The beneficial ownership of which is evidenced by transferable shares or by transferable certificates of beneficial interest,
3. Which would be taxable as a domestic corporation but for the provisions of part II, subchapter M, chapter 1 of the Code,

\(^\text{11}\)Reg. Sec 1-856-1 (a).

\(^\text{12}\)Reg. Sec 1.856-1 (b).
(4) Which does not hold any property primarily for sale to customers in the ordinary course of its trade or business,

(5) The beneficial ownership of which is held by 100 or more persons,

(6) Which would not be a personal holding company (as defined in section 542) if all its gross income constituted personal holding company income (as defined in section 543). 13

In general, the organizational requirements for a R.E.I.T. as set forth in the Revenue Code can be grouped into the following three categories: (1) those dealing with ownership, (2) those dealing with the purpose and make-up of the trust, and (3) the requirement for trustee administration. These three stringent requirements must be properly met before a trust can receive special tax consideration. Each of the requirements is examined in detail in the sections which follow.

Ownership Requirements

The Internal Revenue Code dictates that ownership of the trust shall be evidenced by transferable shares or transferable certificates of beneficial interest. The Code further imposes two prohibitions against concentration of ownership in the trust which could result in the trust's being used as a personal tax gimmick rather than as an investment medium for the public at large. 14

13Regulation Section 1.856-1 (b) (6) does not reflect an amendment to the 1954 Code Section 856 (a) (6) made by Public Law 88-272 which requires the concept of "adjusted ordinary gross income" to be applied in determining whether personal holding company status exists.

14Regs. Sec 1.856-1 (b) (2); Regs. Sec 1.856-1 (b) (4).
The first of these requirements is that the trust must have at least one hundred beneficial owners. This restriction is similar to the one which regulated investment companies must meet to come under the Investment Company Act of 1940. The obvious intention of this requirement is to insure diversity of ownership. In order to prevent an inadvertent disqualification of a trust through an over accumulation of shares by stockholders, the Code states that this requirement need be met only 335/365ths of any fiscal year of the trust.\footnote{Regs. Sec 1.856-1(d). The same regulation states that the trustee, transferable-share, corporate-like-structure, and property-limitation requirements must be met all year long.}

The second prohibition has been set up to prevent the trust from becoming a personal holding company. The regulation states that if at any time during the last half of the trust's taxable year more than 50 per cent of the value of its outstanding stock is directly or indirectly owned by not more than five individuals, the trust actually is a personal holding company and not eligible for special tax treatment.

**Trustee Administration Requirement**

The Revenue Code requires that the trust must be managed by one or more trustees. The trustee must be a person who holds legal title to the trust's property, has continuing exclusive managerial authority over the trust, and conducts the trust's affairs as well as manages
and disposes of its property.\textsuperscript{16} There must be more than a mere fiduciary relationship involved, but the trustee must not, at the same time, have any direct or indirect interest in any contractor charged with servicing and managing the trust's property.\textsuperscript{17}

The trustees are elected by the shareholders, and like corporation directors, delegate day to day management to officers while retaining overall responsibility for operations.

\textbf{Purpose and Structure Requirements}

Congress has clearly stated in the adopted regulations that special tax consideration will be accorded only to passive investment in real estate. In order to insure that a qualified trust does not engage in an active business enterprise, the trust is prohibited from holding any property primarily for sale to customers in the ordinary course of business operations. The regulations state that the question of whether property is held for sale to customers in ordinary trade depends upon the facts and circumstances in each case.\textsuperscript{18}

Unfortunately, this failure on the part of the regulations to provide guidelines regarding property sales has the tendency of

\textsuperscript{16}Recognizing the problems involved in transferring title upon change of trustee and that some states do not permit trusts to hold title, Reg. Sec 1.856-1(d)(1) considers title to be held by the trustee if it is held in the name of the trust, in the name of the trustee, or in the name of a nominee for benefit of the trust.

\textsuperscript{17}Reg. Sec 1.856-1(d)(1).

\textsuperscript{18}Reg. Sec 1.856-1(d)(4); Regs. Sec 1.856-1(d)(3).
"handcuffing" property to a trust. Reluctant to take a chance in which their qualified standing might be lost, trusts tend to hang on to property rather than adjust their portfolios to the changing real estate market. 19

A second related requirement is that the trust must be so organized that in the absence of the R.E.I.T. legislation it would be taxable as a domestic corporation. It must therefore have the corporate characteristics of limited liability, continuity of life, centralized management, free transferability of interests, association of investors, and an objective of carrying on business and dividing the gains.

**Income Requirements**

It was Congressional intent also that special tax consideration be given only to those trusts whose assets were primarily of a real estate nature and whose income was primarily derived from passive investment rather than active management of property. The income requirements are divided into three categories, all three of which must be met to qualify as a tax-favored R.E.I.T. 20

**The Ninety Per Cent Test.** Ninety per cent or more of the trust's income must be derived from certain sources defined in the Code. These sources include dividends; interest; rents from real property; gains on disposition of stock, securities, or real estate assets;

---

19 Roberts, *op. cit.*, pp. 47-8

20 Code Sec 856(c)(2).
and abatements or refunds from real property taxes. This test effectively prevents a trust from qualifying as a R.E.I.T. while conducting any substantial business venture or while engaging in any other nonpassive type of real estate activity.

The Seventy-five Per Cent Test. Although the 90 per cent test is similar to that which must be met by a security investment company, the 75 per cent and 30 per cent tests are peculiar to real estate trusts.

The second income test requires that at least 75 per cent of the trust's income must come in some way from real property interests. These sources as enumerated in the Code include the following: rents from real property, gains from the sale of real property, mortgage interest, dividends and distributions from other "qualified" R.E.I.T.s, and real estate tax abatements or refunds. These sources are analogous to those defined under the 90 per cent test except that the dividend, interest, and gain sources are further qualified to include only returns from real estate activities.

The Thirty Per Cent Test. In order to prevent speculative trading operations the Code dictates that a real estate investment trust will fail to meet "qualified" status if 30 per cent or more of its gross income consists of gains from the sale or other disposition of securities held for less than six months, or from the voluntary sale or disposition of real property interests held for less than four years.

This requirement, together with the proscription against holding property primarily for sale in the ordinary course of business, will
prevent the trust from "wheeling and dealing" in properties and insure its passive status.

General. As noted previously, all three of the gross income requirements must be met during the year. At least 75 per cent of the gross income must be from real property or real-estate related sources. Another 15 per cent of the income must be from real estate sources, or from the sources listed under the 90 per cent rule, or from a combination of both sources. The remaining 10 per cent of the gross income can come from any source.

To insure that misunderstandings do not arise, the Treasury regulations clearly define what is considered proper real estate income and also clarify concepts and terms cited in the Code.

The effect of these requirements will be to concentrate trust investments in real property and force trustees to plan properly in order to meet the tests at year's end.

Investment Requirements

In order to insure that a R.E.I.T.'s activities remain primarily in the real estate area, the Revenue Code imposes certain limitations on the investments of the trust. Two tests have been established and must be met by a qualifying trust at the end of each quarter of its taxable year.21

Real Estate Asset Test. The first test has been set up to see that the bulk of the trust's investments would actually be in real estate and real-estate related assets. The Code requires that at least

21 Code Sec 856(c)(5)(A); Code Sec 856 (c)(5)(B).
75 per cent of the value of the trust's assets be in the form of real estate assets, \(^{22}\) cash, cash items (including receivables), and government securities. Treasury regulations define what constitute acceptable real estate investments and how such interests are to be handled.

**Non-Real Estate Securities Test.** The second test which must be met requires that not more than 25 per cent of the value of the trust's total assets may be in securities other than government securities or real-estate related securities.

Jack E. Roberts in an article in *Major Tax Planning for 1961* says this rule is an "unnecessary and apparently harmless result of hurried drafting... Actually," he continues, "if the 75 per cent test were met it would be impossible to fail to meet this 25 per cent test."\(^{23}\)

The second rule further states that a "qualified" R.E.I.T. cannot own more than ten per cent of the outstanding voting stock of any one issuer, nor invest more than five per cent of its own assets in any one issuer. These percentage restrictions apply only within the framework of the 25 per cent test—that is, to non-real estate assets. A real estate trust may own more than ten per cent, or invest more than five per cent of its own funds, in another real estate investment trust.

**Determination of Status.** Treasury regulation section 1.856-2(d)(3) requires that the trustees revalue the trust's assets each quarter to apply the previously mentioned tests. Should the trust fail to meet

\(^{22}\)"Real estate assets" as defined by Code Sec 856(c)(6)(b) includes: interests in real property, interests in mortgages on real property, and shares or certificates in qualified R.E.I.T.

\(^{23}\)Roberts, op. cit., p. 52.
the requirements solely because of the revaluation (no assets were bought or sold during the quarter, but non-real estate assets increased in value) the trust would not be regarded as having failed the tests. However, with but a single acquisition during the quarter, revaluation could result in disqualification. In the case of a disqualification, the trust has 30 days after the quarter's end to requalify by a proper adjustment of its investments.\textsuperscript{24}

\textbf{Miscellaneous Requirements}

Listed below are two of the more important and basic requirements set forth by the \textit{Revenue Code} which have not been covered under the organizational, income, and investment limitations.

\textbf{Independent Contractor}. Still another restriction imposed to insure passive status is the requirement that active management of the trust's property be delegated to an independent contractor. The regulations provide guidelines which enumerate the functions the trust can perform and still maintain its status.\textsuperscript{25}

Generally, services customarily provided by a landlord can be provided by the trust through an independent contractor. All other services must be furnished by an independent contractor who is not subject to the control of the trustees in the performance of his services. The contractor must make a separate charge for his service and no part of that payment may become part of the trust's income.

\footnotesize{\textsuperscript{24}Code Sec 856(c)(5).}

\footnotesize{\textsuperscript{25}Regs. Sec 1.856-4(b)(3).}
The Code states that the following will not qualify as independent contractors:

1. A person who directly or indirectly owns more than 35 percent of the trusts stock at any time during the year.

2. A partnership, corporation, or other entity if one or more persons who directly or indirectly own more than 35 percent of the entity's stock, assets, or profit also own more than 35 percent of the trust's stock.

**Election to be Taxed as a R.E.I.T.** Simply meeting the above requirements does not automatically qualify a trust for special tax treatment. It must file an election statement with its tax return for the first year in which it desires to be treated as a "qualified" R.E.I.T. Each year thereafter the trust will receive the special consideration as long as it continues to meet the requirements. 26

---

26 Code Sec 856(c). Since net operating losses of a "qualified" trust can neither be passed on to shareholders nor carried to another year, it might be more profitable for the new trust to postpone election until R.E.I.T. status would be worthwhile.
CHAPTER III

A COMPARISON OF REAL ESTATE INVESTMENT VEHICLES

The third chapter presents a cursory look at the different types of real estate investment vehicles. Each form of ownership is analyzed from a number of viewpoints with special emphasis being placed on organization, liability, management, control, and tax status.

For the sake of organization these investment forms have been divided into two groups—real estate syndicates and real estate corporations. In this paper the term "syndicate" refers to any form of organization (other than a R.E.I.T.) in which investors pool resources to invest in real estate, but remain unincorporated. 27

REAL ESTATE SYNDICATES

A real estate syndicate is an association of investors who pool their financial assets to purchase, hold, and dispose of real estate through the agency of a manager or other representative. The syndicate agreement sets forth the manner in which title is to be taken, the property is to be managed, interests are to be transferred, and how other problems are to be handled.

27Under the tax laws there is no separate type of taxable entity known as a "syndicate." Such organizations are taxable as partnerships or as corporations. The definition of a partnership under Code Section 7701(a)(3) includes a "syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not...a trust or an estate or a corporation."
A syndicate is simple to create, simple to terminate, and a means of either operating or speculating in real estate. It enables small investors to share in the profits of a large financial venture, and in the event of unprofitable operations, to spread the loss among the many owners without serious financial embarrassment for any one individual. Usually, syndicate investors are more interested in a quick profit rather than in long-term ownership.28

Single Proprietorship

Though not technically a syndicate (it lacks an association of investors), the single proprietorship has been included in this classification because it has many of the characteristics present in a syndicate.

Undoubtedly, the single proprietorship is the simplest and most common means of holding property. It is easy to organize, and the owner maintains complete control over management of the property. The owner also realizes all profits and losses resulting from operations and is taxed on the firm's earnings at the regular individual rate whether or not the earnings are withdrawn from the business. However, the owner faces unlimited liability for his business debts and also allows his business property to be subject to liens resulting from personal debts.

This form of ownership is highly limited by the technical and financial ability of its owner. It is popular with individuals who

are primarily interested in an active rather than passive investment in real estate.\textsuperscript{29}

**Tenancy in Common, Joint Tenancy, and Tenancy by Entirety**

The ownership of real estate by two or more persons each of whom has an undivided interest is called a tenancy in common. Upon the death of one of the associates, his interest passes on to his heirs or the individuals named in his will. Owners share in income and obligations according to their interest in the business. Any owner can sell his share in the property or bring action to have the property sold.

Joint tenancy is basically the same except that the individual interest of an owner is "with survivorship." If one owner dies, his interest passes to the remaining owners. Should one member sell his interest, the new owner becomes a tenant-in-common with the others.

In some states, when husband and wife take title to a piece of property together, and unless the conveyance instrument indicates to the contrary, each becomes owner of the entire property and a tenancy by entirety is formed. Neither can convey the property nor force its partition. If either dies, the entire property is then owned by the survivor.\textsuperscript{30}

These forms of ownership are primarily of interest to small groups

---


of investors who are interested in acquiring a particular piece of property rather than to the investor public in general. However, they should be kept in mind as potential forms of real estate ownership.

**Real Estate Partnerships**

A real estate partnership is the usual form of investment in property when incorporation is not desired. Under the law a partnership is an association of individuals rather than a legal entity. The partnership name is merely a designation for the group of investors. The partnership form permits the pooling of the capital and talents of the partners to increase the scale of operation and add stability.

**A Real Estate General Partnership**

In a general partnership each of the associates contributes his agreed share of the necessary equity financing funds. The partnership agreement specifies how management and profits of the business are to be shared. Under this form each partner can usually bind the group in partnership matters, and each is usually liable for the entire debt created by the partnership.

From the tax viewpoint the advantage of a partnership is that although it files a tax return, it pays no tax of and in itself. Each partner picks up his share of the total financial return—both operating profit and capital gains—and includes this share on his own personal tax return.
The chief disadvantages to the small investor are the problems of unlimited liability and control. There is also the element of instability which results because the death of a general partner terminates the partnership. These disadvantages have been the primary deterrents in the choice of the general partnership as an investment medium for the large number of small investors.\(^{31}\)

Real Estate Limited Partnership

A large majority of the real estate syndicates formed during the late 1950's were organized as limited partnerships. This form of organization has certain advantages in those states which recognize its existence and which have adopted the Uniform Partnership Act and the Uniform Limited Partnership Act.\(^{32}\)

Three corporate-like traits characterize the limited partnership. Organized under state law, limited partnerships permit those partners with limited interests to restrict their liability for partnership losses to the amount of their capital contribution. Second, state law usually recognizes that the partnership continues to exist despite the death or withdrawal of a limited partner. Finally, limited partners are forbidden to participate in management of the partnership's business. Despite these similarities to a corporation, limited partnerships are taxed as ordinary partnerships.\(^{33}\)

---

\(^{31}\) Maisel, *loc. cit.*


Generally, a typical limited partnership is made up of three to five general partners who have full control of the organization and have unlimited liability. Limited partners subscribe for a specified amount of invested capital. Their liability is limited to the amount of their subscription, and their shares are freely transferrable. These limited partners may have no voice in management. The organization operates under a carefully drawn partnership agreement to insure it does not lose its tax advantage through violation of the strict requirements imposed by state law, or through an Internal Revenue ruling that its operations have become those of a corporation. The limited partnership need not dissolve because of the death of a limited partner, whereas it is terminated by the death of a general partner. Here again the partnership itself pays no tax. The partners include their share of earnings on their personal tax return.

This form of organization was very popular during the past decade when real estate barons like William Zeckendorf were able to pool the resources of thousands of investors to make "killings" in the real estate market. But it began its decline when some syndicates failed and others were found to be guilty of improper action.34

REAL ESTATE CORPORATIONS

The most common form of organization adopted when a real estate investment requires substantial financing has been the corporation. The corporation is a creature of state law, and as such its organization is strictly governed by that law. However, unlike a realty

trust, a real estate corporation is not restricted in regard to in-
vestment, source and distribution of income, management, disposition
of property, or number and percentage of interest held by shareholders.
The corporation is a legal entity and therefore can sue and be sued,
and can hold property in its own name.

The real estate corporation has a number of advantages over the
real estate syndicate. First, the shareholder has limited liability.
His total loss is limited to his capital investment in the corpora-
tion. Second, the ability of a corporation to secure additional funds
enables it to diversify both geographically and property-wise. It can
invest in more costly real estate and numerous different types of prop-
erty. Third, continuity of life is another characteristic of a corpora-
tion. The death of a shareholder does not terminate the business. A
fourth advantage is the ease with which shares of the corporation can
be transferred. Finally, a corporation has centralized management. The
separation of ownership and management allows the small investor to pur-
chase equity in a firm directed by professional managers.

There are also certain disadvantages associated with the corporate
form. It is a costly organization to set up. Initially, state fees
must be paid and legal counsel employed. Thereafter, the corporation
must maintain certain records in a specified form and continue to pay
an annual state franchise tax.

But the major disadvantage of a real estate corporation from an
investor's viewpoint is the double taxation it faces. The corporation
pays one tax on its earnings and its stockholders pay a second tax when
the earnings are distributed. However, distributions in excess of pro-
fits are treated as a nontaxable return of capital. Once the investment
basis has been recovered by the investor, excess distributions are then treated as capital gains.

Capital gains earned by the corporation itself cannot be passed through to the shareholders. If the gains are distributed, they are taxed as ordinary dividends to the recipients.

Losses also cannot be passed through to shareholders. Such losses belong to the corporation and can be carried back three years or forward for five years to get a tax refund or reduce future tax liability. Stockholders, therefore, are not affected directly by losses.  

REAL ESTATE INVESTMENT TRUSTS

Chapter Two presented a detailed analysis of the organization of a R.E.I.T., and it need not be repeated in this comparison chapter. The principal advantage of a real estate trust over other investment media lies in the area of taxation. The holder of a R.E.I.T. certificate receives the organizational advantages of the corporation and the single-tax advantages of the partnership. The following section presents a discussion of the tax liability of a R.E.I.T.

Taxation of Real Estate Investment Trusts

The tax liability of a "qualified" real estate investment trust is a simple matter to determine. If the trust distributes all of its taxable income, it faces no income tax liability whatsoever. In the event the trust meets the 90 per cent test and distributes at least

---

that percentage of its taxable income, it will pay a tax on its undistributed profits at the ordinary corporate rate. Should the trust fail to meet the 90 per cent requirement, its entire earnings will be taxed at the corporate rates.

To compute the "real estate investment trust taxable income" five adjustments must be made to taxable income as it would be computed by a typical corporation. These include:

(1) Certain special deductions provided by the Code shall not be allowed. These include: deduction for partially tax exempt interest, deductions for dividends received, and others specified in part VIII of subchapter B of the Code;

(2) The deduction for dividends paid shall be computed without regard to capital gain dividends;

(3) The excess, if any, of the net long-term capital gain over the net short-term capital loss shall be excluded;

(4) Section 443 (b) of the Code regarding change of accounting period shall be disregarded;

(5) The net operating loss deduction provided in Section 172 shall not be allowed.

Should an organization meet every other requirement to qualify as a R.E.I.T. and fail to meet the 90 per cent test, it would not receive special tax consideration and would invoke additional unfavorable

---

36 Regs. Section 1.857-3.

37 To qualify for this deduction a dividend need not be declared and paid in the year earned, but must be declared prior to the due date for filing the trust's tax return and paid not later than the date of the first regular dividend payment made after the declaration, and not later than twelve months after the close of the taxable year.
tax treatment. In this instance the "nonqualifying" trust would still be bound by the prohibition of the use of certain deductions as enumerated in the previous paragraph. Capital gains which are normally a tax-free distribution of any other trust would be taxable in this situation and the trust would be taxed exactly as a corporation.\textsuperscript{38}

However, should the trust fail to meet one of the other requirements (other than the distribution test), the income adjustment would be inapplicable. The trust would be taxed as an ordinary corporation, but capital gain distributions would retain their preferred tax status.\textsuperscript{39}

A serious problem facing trusts is the loss of any adjustment for net operating losses. The trust is prohibited from either passing losses through to the beneficiaries or from carrying loss back or forward to other taxable years. There exists an inability to offset an operating loss against other income and yet maintain "qualified" R.E.I.T. status.

\textbf{Taxation of Real Estate Investment Trust Beneficiaries}

Dividends received from a real estate trust are treated as ordinary income and are included in the shareholder's gross income for taxable years in which they are received. These distributions are not eligible to be used under the dividend deduction and dividend credit provisions of the \textit{Revenue Code}.

\textsuperscript{38}Adjustment two noted in the previous paragraph states that the dividend-paid deduction is computed without regard to capital gain dividends. In effect these capital gains are being taxed at corporate rates since their distribution is not deducted in computing taxable income.

\textsuperscript{39}Roberts, \textit{op. cit.}, p. 37.
To the extent of any net long-term capital gain realized, the trust may, at its option, designate its distributions as capital gain dividends. These dividends shall be treated in the hands of the shareholder as gains resulting from the disposition of capital assets held for more than six months.

Although taxation has not been completely avoided, small investors now have the opportunity to partake in large operations without incurring double taxation. Certain disadvantages such as the loss of the dividend exclusion and credit exist. Yet these disadvantages are minor relative to the new opportunities which have opened for the small investor.
CHAPTER IV

KINDS OF TRUSTS

Although Congress has prescribed a rigid code within which R.E.I.T.s must be organized to qualify for special tax consideration, no two trusts are similar in background, condition, and outlook. From the basic regulation a variety of trusts have developed.

Two primary classes of trusts are equity trusts and mortgage trusts. Equity trusts can be further divided into five subclasses—purchase, "blank check," exchange, mixed, and existing trusts. These trusts use their funds to purchase fee ownership and leaseholds in real property.

Mortgage trusts differ in that they use their investors' funds to purchase mortgages and other encumbrances on real property.

This chapter looks at the different kinds of trusts and the techniques which differentiate them.

"BLANK CHECK" TRUSTS

This form of trust determines what properties to exploit after it has received its capital from the sale of trust certificates. A public offering of trust shares is made before any property is acquired and before specific acquisitions have been investigated.

An investment policy is set forth in the trust's prospectus which recites the factors which the trustees will deem favorable in selecting properties. The most common factors desired include:

(1) A large mortgage with a long maturity.
(2) Eligibility for large depreciation deductions.

(3) Prospects for an appreciation in value.40

This form of trust gives the trustees the greatest amount of flexibility and, since there is little to disclose with respect to operating statements, historical earnings, etc. in clearing with the Securities and Exchange Commission, registration time is kept to a minimum. At the same time the trustees are also in a good bargaining position since they have the funds and know exactly what they can do.

Although often easiest to clear with the S.E.C., a "blank check" trust is usually the hardest with which to go into business unless an underwriter will take most—if not all—of the offering, or the names of the promoters or trustees are "magic" to the investing public.

In effect investors are asked to buy something with nothing in it. The investment might remain almost unproductive for a considerable period and, initially, the trust may show a drop in the price of its shares until its money is invested in income producing property. The trust is under pressure to invest its funds productively as quickly as possible. But millions of dollars cannot be invested prudently very quickly.

As an example, at the end of its first fiscal year Greenfield Real Estate Investment Trust of Philadelphia had still not found any property it was willing to buy. The $9.4 million it had raised from investors was sitting in Treasury Bills and producing earnings of only

2.5 per cent—earnings which were subject to corporate tax because the trust did not qualify for special tax treatment since it did not meet the 75 per cent real estate income requirement. 41

EXCHANGE TRUSTS

Another popular means used in the acquisition of property by a trust is through an exchange of trust shares for the property. This exchange takes place as a tax-free transaction qualifying under Section 351 of the Internal Revenue Code.

There has been a significant growth in exchange or swap trusts. It is an attractive transaction to the owners of real estate who desire diversification but do not wish to pay a current capital gain tax. At the same time trust promoters are assured that the property is available during the delay in getting registered.

Usually, in this type of transaction—especially with a strong real estate market as exists today—chances are that the fair market value of the property exceeds its basis in the hands of its owner. Upon any tax-free exchange with the owner, the trust will take the owner's basis for depreciation purposes and for computing gain or loss on sale. In effect this dilutes the holdings of the other owners and causes distortions in the trust's income picture.

Normally in an exchange involving the pooling of property of a number of individuals, there is also a pooling of potential capital gain tax. More shares would go to the owner of a high basis property

41 Donald Seligman, "A New Road into Real Estate," Fortune, January, 1964, pp. 177-78.
than to the owner of an equally valuable low basis property because in the latter case the potential gain—and tax—when the property is sold is greater.\textsuperscript{42}

This method is also prone to abuse. Property owners could very well promote a REIT and attempt to swap properties in exchange for shares with values being placed on the property in excess of what the properties would normally be able to sell for. This, of course, could affect the marketability of the trust's shares.

Trusts are not permitted actively to solicit tax-free exchanges. The Treasury Department announced it would not immediately recognize the tax-free nature of any wide scale solicited exchange.\textsuperscript{43}

\textbf{PURCHASE TRUST}

A popular method of acquiring property is via the purchase route. Under this method the promoters or trustees first determine what property they wish to purchase and then they go out to the investors for funds.

Unlike the "blank check" trust which has no particular investment property in mind, the purchase trust has committed itself to certain property and the potential investor has a good idea of what the trust yield is likely to be. Also, since the trust can take over the property almost immediately, its money is invested at once and it can receive special tax benefits almost from its inception.


\textsuperscript{43} Treasury Information Release 312, March 13, 1961.
Specific properties to be acquired together with their operating histories must be described at length in the S.E.C. registration statement. Examples of early filings of trusts are replete with deficiencies in supplying sufficient historical data of the properties to be purchased.

Trusts usually insist that the purchase contract bind seller to make available historical data, operating records, etc. which the S.E.C. will require. The availability of financial statements tends to comfort the S.E.C. and other regulatory bodies who normally look with suspicion upon unrestricted funds available for trustee investment.

Before the trustees can represent to the public that the funds received from the sale of securities will be used for a specific investment, they must assure themselves that the property will be available when the registration becomes effective. In effect, the property must be taken off the market for the three to nine months of registration proceedings. Naturally, owners will expect substantial remuneration in the form of expensive options. This cost together with heavy legal and accounting fees and other organizational costs constitutes one of the most difficult problems facing trusts.44

Another disadvantage results when all money is to be used for specific purchases. Here the trustees' freedom becomes quite limited. Probably a combination of a purchase and "blank check" trust would yield the optimum operating conditions.

---

MIXED TRUSTS

A fourth kind of trust can be thought of as a kind of a hybrid—a combination purchase trust and "blank check" trust. The promoters of this form seek investment funds with the intention of acquiring a specific piece of property with a certain percentage of the proceeds, and to use the remainder of the proceeds on a "blank check" basis.45

This is considered a desirable form because purchase of the property described in the prospectus gives the investing public an idea of the type of investment the trust will be making with the "blank check" proceeds.

Although there is almost immediate income, part of the funds are held for a time before investment and the overall return will be low until the total investment is made.

EXISTING TRUSTS

Existing trusts are those trusts which were in operation when the REIT law passed and subsequently reorganized to qualify for the special tax consideration.

These trusts have the advantages of a seasoned management and little or no organizational costs. However, much of the trust's property has already been depreciated and charges are not as high as the trustees would like.46

46 Ibid.
The oldest, and until recently the biggest, of trusts is Real Estate Investment Trust of America. This conservative Boston trust can trace its origin back to the nineteenth century when the trust concept per se emerged. Much of the credit for passage of the 1960 REIT legislation belongs to the lobbying efforts of REITIA. After passage of the legislation this trust was the first to make a public offering of stock.47

MORTGAGE TRUSTS

The market, it should be noted, has been more responsive to the capital needs of the mortgage trusts—a group which, among other things, is inherently unable to confuse earnings with depreciation since it does not hold title to property.48

Although REITs in general have received a cold shoulder from Wall Street, trusts which acquire only mortgages have been able to acquire capital with relative ease. Operating much like savings and loan associations, mortgage trusts have become a vital force in the residential mortgage market.

In the early years of REIT organization the only type of trust which was established was the equity trust. These trusts, as previously explained, were involved with the acquisition and ownership of improved, real property. Later, in September of 1961, out of this new investment concept came the first mortgage investment trust—First

47 J. Richard Elliott, Jr., "Fresh Appraisal; the Rewards and Risks in Real Estate Investment Trusts," Barron's, April 5, 1965, p. 5.

48 Ibid.
"mortgage Investors. As distinguished from the equity trust, a mortgage trust operates under a policy of acquiring mortgage debt obligations encumbering real property rather than the property itself.

Table I presents data concerning the three largest mortgage real estate investment trusts. Two of these three trusts—Continental Mortgage and First Mortgage—are also the largest of all REITs in existence. Each holds assets which exceed the holdings of the largest "real-property" trust by almost twenty million dollars (also see Table III).

There are certain distinctions in the nature and operations of the equity and mortgage trusts. The primary source of income in an equity trust is rent, while a mortgage trust derives its income from interest earned on obligations held and discounts earned during amortization of the mortgages.

The income of an equity trust can be fixed or volatile. Rental paid on a net lease basis would constitute fixed income. A lease agreement based on percentage of sales would make rental income subject to some fluctuation. Although the interest income of a mortgage trust is fixed by nature, its discount income will vary in relation to the market cost of money.

An equity trust obtains capital gains through the sale of its property. In the mortgage trust such gains result through the sale of a mortgage at a higher price than the purchase price.

Most equity trusts find a large percentage of their assets invested in one or a few pieces of property. Mortgage trusts, on the other hand, invest in more units of inventory (mortgages) and have less of a con-
### TABLE I

**ASSETS AND DEBT OF SELECTED REAL ESTATE INVESTMENT TRUSTS**

In thousands of dollars

<table>
<thead>
<tr>
<th>TRUST</th>
<th>Fiscal Year Ended</th>
<th>Total Assets</th>
<th>Net Assets</th>
<th>FHA-VA Mortgages Held</th>
<th>Con-Dev Loans Held</th>
<th>Other Paper Held</th>
<th>Long Term Debt</th>
<th>Short Term Debt</th>
<th>L.T. Debt Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>CONTINENTAL</td>
<td>3-31-65</td>
<td>76,669.1</td>
<td>25,169.4</td>
<td>19,627.3</td>
<td>-</td>
<td>48,784.5</td>
<td>49,250.0</td>
<td>2,250.3</td>
<td>69.2%</td>
</tr>
<tr>
<td>FIRST MORTGAGE</td>
<td>1-31-65</td>
<td>68,979.1</td>
<td>15,111.1</td>
<td>-</td>
<td>-</td>
<td>68,448.4</td>
<td>18,852.7</td>
<td>35,350.5</td>
<td>27.3%</td>
</tr>
<tr>
<td>SOUTHEASTERN</td>
<td>7-30-65A</td>
<td>22,746.6</td>
<td>8,795.9</td>
<td>-</td>
<td>7,574.0</td>
<td>12,762.1</td>
<td>12,180.3</td>
<td>1,770.3</td>
<td>53.5%</td>
</tr>
</tbody>
</table>

A-Nine months ended; B-No breakdown available; C-Long term debt/Total Assets

**Sources:**


*Handbook of Member Trusts*, National Association of Real Estate Investment Funds.
centration of assets in a particular investment.

Equity trusts deal in tangible fixed property while mortgage trusts deal in intangible notes and mortgages. As a result, the shareholder in an equity trust can obtain a tax benefit resulting from depreciation of the trust's physical property. The mortgage trust investor does not receive this advantage since property obligations are not depreciable.

The assets of a mortgage trust are in a better secured position on property liquidations than those of an equity trust. The debt obligations held by a mortgage trust usually have first priority and take precedence over other obligations and equities in the real property.

Normally an equity trust will limit borrowing on property (that is, purchase mortgage encumbered property) to not over seventy-five per cent of the value of the property. Mortgage trusts rely much more on debt financing to acquire capital for enlarging investment in credit paper.

Since mortgages are constantly being paid off while the physical assets of an equity trust are relatively fixed, managers of a mortgage trust are continually faced with the problem of reinvesting funds received through amortization or final payment of mortgages. For this reason assets of a mortgage investment trust are considered to be more liquid than those of an equity trust.

Although mortgage investment trusts have been readily accepted, they have had their share of problems. The Internal Revenue Service at one time decided that the income received by First Mortgage Investors
from short term construction loans did not qualify as "passive" and for one quarter the trust was not officially a trust.

This ruling struck at the basic operating technique of the mortgage trust—high yielding construction and development loans which enable trusts to borrow at bank rates and still pay investors six to eight per cent. FHA and VA mortgages with their 5 per cent return would hardly permit such a distribution to trust investors.\textsuperscript{49}

First Mortgage and Continental Mortgage Investors reacted with such alarm to the Revenue Department decision that former I.R.S. Commissioner Caplan interceded to clarify the Code and exempt the trust.\textsuperscript{50}

On another occasion an early prospectus of First Mortgage Investors had to be revised to eliminate the word "fund" from the title. The S.E.C. felt the word had a connotation which might mislead the public into believing the trust to be a regulated investment company operating under the Investment Act of 1940.\textsuperscript{51}

Recent market experience has shown that mortgage REITs have been able to compete satisfactorily with commercial banks in advancing construction and development funds. Their favorable competitive position results from the trust's highly developed knowledge of the field, the special assistance this knowledge allows them to offer, and their ability to take on an entire project which may be beyond the reach of a local institution.

\textsuperscript{49} This disadvantage of holding only FHA and VA loans is partially offset by the almost riskless investment in a government secured portfolio.

\textsuperscript{50} J. Richard Elliott, "Fresh Appraisal; The Rewards and Risks in Real Estate Investment Trusts," \textit{Barron's}, March 15, 1965, p. 3.

\textsuperscript{51} Williamson, \textit{op. cit.}, p. 76.
The advent of a tighter money market has for the most part been in favor of mortgage trusts. Although the cost of short term borrowing has risen, most trusts have found they are able to pass higher costs along to developers and builders. At the same time, capital being returned through the amortization of first mortgages can be re-invested at a higher rate of return.\footnote{52}

In light of demographers' predictions, trust managers are highly optimistic about the future. Only money market conditions in the months ahead may provide some obstacles. The investor must be conscious of the fact that he is still buying management and the results of his investment will depend largely on that management's ability.

Some trusts hold both real property interests and mortgage-obligation paper. Seven of these larger 'combination' trusts are included in Table II. Generally, these trusts invest the major portion of their capital in real property.

Of the seven trusts listed in the table, four have more than 90 per cent of their assets in real estate. The largest dollar value holding of mortgages is the $2.5 million held by Sixty Real Estate Trust. This represents only about 15 per cent of the trust's total assets. It is, however, the greatest percentage holding of mortgage paper by any of the seven 'combination' trusts. Only Pennsylvania REIT among the other six listed trusts holds $2 million in mortgages—and this represents only 4.4 per cent of its assets.

The other trusts as shown by Table II hold less than $775,000

\footnote{52"Mortgage Investment Trusts," \textit{Financial World}, March 30, 1966, p. 31.}
in mortgages which make up percentage holdings of debt obligations ranging from .54 to 6.2 per cent of the individual trust's total assets. It appears that most trusts feel a greater return can be obtained from real property investment. Possibly, some of the debt-paper investment is made simply to meet the investment requirements of the REIT law.
### TABLE II

**ASSETS OF SELECTED "COMBINATION"***

**REAL ESTATE INVESTMENT TRUSTS**

In thousands of dollars

<table>
<thead>
<tr>
<th>TRUST</th>
<th>Fiscal Year Ended</th>
<th>Total Assets</th>
<th>Net Assets</th>
<th>Real Estate -Net</th>
<th>% Assets in Real Estate</th>
<th>Mortgages Held</th>
<th>% Assets in Mortgages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pennsylvania REIT</td>
<td>6-30-65</td>
<td>44,553.6</td>
<td>5,834.9</td>
<td>10,724.8</td>
<td>91.4</td>
<td>2,000.0</td>
<td>4.4</td>
</tr>
<tr>
<td>REIT of America</td>
<td>10-30-65</td>
<td>37,125.2</td>
<td>26,087.0</td>
<td>35,843.5</td>
<td>96.5</td>
<td>656.0</td>
<td>1.7</td>
</tr>
<tr>
<td>Prudential</td>
<td>10-30-65</td>
<td>28,499.1</td>
<td>4,389.9</td>
<td>21,110.1</td>
<td>74.2</td>
<td>155.0</td>
<td>.54</td>
</tr>
<tr>
<td>Liberty</td>
<td>12-30-64</td>
<td>17,499.3</td>
<td>7,672.1</td>
<td>16,381.1</td>
<td>96.6</td>
<td>461.9</td>
<td>2.7</td>
</tr>
<tr>
<td>Sixty</td>
<td>4-30-65</td>
<td>17,108.3</td>
<td>6,250.1</td>
<td>14,424.3</td>
<td>84.3</td>
<td>2,522.8</td>
<td>14.7</td>
</tr>
<tr>
<td>Denver</td>
<td>12-31-65</td>
<td>15,110.2</td>
<td>7,315.0</td>
<td>14,262.3</td>
<td>94.3</td>
<td>682.4</td>
<td>4.5</td>
</tr>
<tr>
<td>Bradley</td>
<td>8-31-65</td>
<td>11,921.5</td>
<td>5,294.6</td>
<td>8,652.7</td>
<td>72.6</td>
<td>741.8</td>
<td>6.2</td>
</tr>
</tbody>
</table>

*Holders of both Real Property and Mortgages

Sources:

- Handbook of Member Trusts, National Association of Real Estate Funds.
CHAPTER V

OPERATIONAL POLICIES OF TRUSTS

Besides varying in their individual makeup, trusts also hold different philosophies regarding such operational policies as debt management, dividend distribution, property investment, and other matters. All trusts use debt financing. Some trusts attempt to reduce outside obligations and build equity. Still others employ the highest possible leverage permitted under the law to maximize the return on invested capital.

Some trusts adhere to a distribution policy which limits dividend payments to earned income. Others pay a dividend which is a combination of earnings and a return of capital. At the other extreme are the trusts which make a distribution which is entirely a tax-free return of capital.

The trustees of some REITs have elected to limit investment to one particular piece of real estate or into a few pieces of property within a narrowly defined geographical area. Most trusts, however, diversify into many different types of property and into a wide geographical area (See Table III).

This chapter highlights some of the different operational policies that trusts can follow.

DIVERSIFICATION

Some of the most fundamental differences among REITs lie in the area of interests held. The distinguishing traits of equity trusts
and mortgage trusts were discussed in a previous chapter; the prior
hold fees or leaseholds in real property, while the latter hold debt
obligations on real estate.

Table III presents data concerning diversification in trust
ownership. Of the twenty trusts listed on Table III only nine have
more than one million shares of beneficial interest outstanding. The
greatest number of shares outstanding is the eleven million issued by
Flato Realty. No other trust even closely approaches this number.
First Union Realty ranks second with 1.9 million shares outstanding.
At the other extreme lies Sixty REIT which has more than $17 million
in total assets, but only 630 outstanding shares.

Essentially the same picture exists as far as the number of in-
dividual shareholders is concerned. Continental Mortgage Trust has
the greatest number of shareholders with 8500. Most of the other
15 trusts for which information is available have from 2000 to 5000
owners of beneficial shares. Twenty-five per cent of these trusts
have fewer that 500 individual shareholders. Certainly, as far as
ownership is concerned, REITs have failed to gain the widespread
acceptance envisioned by Congress.

Equity trusts differ in regard to both geographical location and
type of building held. This also is quite plainly shown by Table III.
Both Denver Real Estate Investment Association and First Union Realty
in Cleveland, Ohio, maintain a portfolio of properties which is located
entirely in their home city. By contrast Pennsylvania and Prudential
REITs have property located in ten states while REITA is in fifteen
Flato Realty is an example of how a trust has been created for the long pull with geographical diversification. Franklin Flato and his associates put together a portfolio by swapping trust shares for ten properties ranging from an apartment in Pennsylvania to a Woolworth building in Texas to shopping centers in Wyoming and California. In addition, Flato's policy is not to acquire new holdings which result in more than 40 per cent of his investment's being located in a single metropolitan area. No more than 25 per cent of Flato Realty's assets will be placed in any single property and it will limit investment in any one type of property to 50 per cent or $10 million, whichever is greater.54

Nor is geographical dispersion the only difference. Some trusts invest heavily in one form of structure while others have diversified their holdings (see Table:III). Bradley Real Estate Trust of Boston has found trouble in its concentration of ownership in retail outlets—especially in Seattle since the World Fair closed. Trusts, such as Pennsylvania, with heavy commitments in apartment buildings, are encountering headaches resulting from the glut in residential housing. Liberty Trust, with over 30 properties, simply hasn't been able to get them to pay off as history indicates they should. Its problem has been the disproportionate number of apartments, motels, and bowling


<table>
<thead>
<tr>
<th>TRUST</th>
<th>Year of Origin</th>
<th>Total Assets$^A$</th>
<th>No. of Shareholders</th>
<th>Shares outstanding$^B$</th>
<th>States Located</th>
<th>Properties Owned$^D$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Continental Mortgage</td>
<td>1962</td>
<td>76,669.9</td>
<td>8500</td>
<td>1,820.6</td>
<td>30$^C$</td>
<td>X</td>
</tr>
<tr>
<td>First Mortgage</td>
<td>1961</td>
<td>68,979.2</td>
<td>5275</td>
<td>1,116.5</td>
<td>41$^C$</td>
<td>X</td>
</tr>
<tr>
<td>U.S. Realty</td>
<td>1961</td>
<td>49,526.0</td>
<td>5050</td>
<td>1,234.0</td>
<td>8</td>
<td>10 2 8 2 5 1</td>
</tr>
<tr>
<td>First National REIT</td>
<td>1962</td>
<td>48,411.7</td>
<td>N/A</td>
<td>1,851.7</td>
<td>8</td>
<td>9 1 3 1</td>
</tr>
<tr>
<td>Pennsylvania REIT</td>
<td>1962</td>
<td>44,553.7</td>
<td>1144</td>
<td>752.7</td>
<td>10</td>
<td>1 5 6 6</td>
</tr>
<tr>
<td>First Union Realty</td>
<td>1961</td>
<td>43,418.5</td>
<td>N/A</td>
<td>1,940.0</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>R.E.I.T. of America</td>
<td>1961</td>
<td>37,125.2</td>
<td>4774</td>
<td>1,283.2</td>
<td>15</td>
<td>5 31 8 4 X</td>
</tr>
<tr>
<td>National Realty</td>
<td>1962</td>
<td>29,662.7</td>
<td>3800</td>
<td>900.0</td>
<td>8</td>
<td>5 3 2</td>
</tr>
<tr>
<td>Prudential</td>
<td>1964</td>
<td>28,449.6</td>
<td>N/A</td>
<td>700.0</td>
<td>10</td>
<td>3 7 4 2 1 X</td>
</tr>
<tr>
<td>Franklin Realty</td>
<td>1962</td>
<td>24,883.9</td>
<td>3000</td>
<td>610.0</td>
<td>7</td>
<td>6 5 1</td>
</tr>
<tr>
<td>Southeastern</td>
<td>1964</td>
<td>22,746.6</td>
<td>3222</td>
<td>1,000.0</td>
<td>-</td>
<td>0 $^C$ X</td>
</tr>
<tr>
<td>American Realty</td>
<td>1961</td>
<td>22,610.0</td>
<td>4500</td>
<td>961.5</td>
<td>6</td>
<td>3 5 1 1 3</td>
</tr>
<tr>
<td>Columbia R.E.I.T.</td>
<td>1963</td>
<td>21,132.4</td>
<td>258</td>
<td>427.6</td>
<td>3</td>
<td>1 7 1</td>
</tr>
<tr>
<td>Greenfield REIT</td>
<td>1961</td>
<td>17,918.7</td>
<td>2644</td>
<td>497.5</td>
<td>4</td>
<td>3 4</td>
</tr>
<tr>
<td>Liberty</td>
<td>1961</td>
<td>17,499.3</td>
<td>2000</td>
<td>954.6</td>
<td>4</td>
<td>5 3 2</td>
</tr>
<tr>
<td>Sixty</td>
<td>1962</td>
<td>17,108.3</td>
<td>164</td>
<td>6.3</td>
<td>9</td>
<td>6 7 10 5 4 1 X</td>
</tr>
<tr>
<td>Denver REI Assoc.</td>
<td>1961</td>
<td>15,110.3</td>
<td>4572</td>
<td>800.0</td>
<td>1</td>
<td>2 2 2 5 X</td>
</tr>
<tr>
<td>Bradley</td>
<td>1961</td>
<td>11,921.5</td>
<td>490</td>
<td>1,010.9</td>
<td>3</td>
<td>4 16 2 X</td>
</tr>
<tr>
<td>Flato Realty</td>
<td>1962</td>
<td>11,637.8</td>
<td>200</td>
<td>11,259.5</td>
<td>5</td>
<td>2 1 7 X</td>
</tr>
<tr>
<td>Commonwealth REIT</td>
<td>1962</td>
<td>9,113.9</td>
<td>N/A</td>
<td>430.6</td>
<td>3</td>
<td>2 2 1 1</td>
</tr>
</tbody>
</table>

A—In thousands of dollars; B—In thousands; C—States in which mortgage trusts has mortgage correspondents; D—Code: (O) Office building, (A) Apartment, (R) Retail store, (I) Industrial, (H) Hotels, motels, (M) Miscellaneous (recreation, undeveloped land, etc.), (P) Paper (mortgages, development loans, etc.); N/A—Not available.

alleys in its portfolio.55

It appears that a portfolio fairly well balanced both geographically or structure-wise is still not a guarantee of safety. Most individual trusts simply invest in areas where trustees feel future strength will lie.

DEBT POLICY

As evidenced by Table IV, a striking difference exists in the approach individual REITs take to organize their capital structure. Certain trusts believe in minimizing mortgages and maximizing equity. Since amortization is kept down, this policy of equity capital financing leads to a maximizing of profits though not necessarily of cash flow. Trusts like REITA and Denver which think in terms of earnings rather than cash flow are advocates of a low-debt policy.

Other trusts like Pennsylvania favor a balance sheet with a high debt position. These trusts find that the higher the mortgage, the lower the equity investment and therefore the higher the percentage return of generated cash. As long as the assets financed by borrowed funds earn more than the cost of borrowed money, the trust is increasing the profitability of the equity investors.

However, debt leverage does involve risk. Improperly used, it reduces an investment to speculation and can be dangerous. In a rising realty market leverage enhances equity; but in a falling market when earnings on borrowed money do not equal the cost of borrowed

money, leverage works in reverse.56

In planning for the repayment of borrowings upon a mortgage, the Trustees must be conscious of the profit distribution requirements set forth in the Code. Cash flow must be planned to insure funds are available to meet distributions required for continued qualification. The interaction of interest and principal payments—as well as depreciation charges—affect cash flow.

Interest payments are actual cash payments which are deductible for income tax purposes and result in a reduction of net income. As interest payments decline, both net income and tax liability increase and, therefore, cash demands also increase accordingly. Graphically, this is shown as follows:

FIGURE I
INTEREST PAYMENTS AND CASH DEMANDS

TAXES AND DIVIDENDS

CASH INTEREST

YEARS


This presents problems to the typical trust with a level payment amortization plan in which the decrease in the interest portion of the regular loan payment is offset by an increase in the principal portion of the payment. Since the increase in the principal payment is neither a reduction of taxes or income, the total cash needed will increase because the net cash demand of the loan remains constant while additional cash is required for satisfaction of dividend and tax requirements.\textsuperscript{57}

Data concerning debt policies of some of the larger trusts are presented by Table IV. The heaviest borrower on the table is Pennsylvania REIT which maintains a debt position of almost 87 per cent. At the other extreme lies Real Estate Investment Trust of America. This old trust has kept borrowing down to a 27 per cent level. Generally, it can be seen from the table that most of the trusts have incurred debt ranging from 50 to 75 per cent of the total value of the individual trust's total assets.

The same table also reflects the fact that property-holding trusts have turned primarily to mortgage borrowing over other forms of debt financing. The mortgage trusts do not hold real property, but have accumulated a debt position comparable to the other trust forms.

The least leveraged of all trusts by a wide margin is Real Estate Investment Trust of America. At year end its equity ratio stood at 73 per cent. Just one-fourth of the pre-depreciation value of its properties is mortgaged. Trustees feel that a 50 per cent debt limit is fairly safe, but they have no plans to achieve such a limit. They

\textsuperscript{57}Grant and Scheifly, \textit{op. cit.}, p. 245.
### Table IV

**Debt Position of Selected Real Estate Investment Trusts**

In thousands of dollars

<table>
<thead>
<tr>
<th>Trust</th>
<th>Fiscal Year Ended</th>
<th>Total Assets</th>
<th>Real Estate -Net</th>
<th>Mortgages Payable</th>
<th>% R.E. Mortgaged</th>
<th>Total Debt</th>
<th>% Total Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity Trusts</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. Realty</td>
<td>12-31-64</td>
<td>49,526.0</td>
<td>48,756.4</td>
<td>31,277.2</td>
<td>64.1</td>
<td>40,444.3</td>
<td>81.7</td>
</tr>
<tr>
<td>First National</td>
<td>12-31-65</td>
<td>48,411.7</td>
<td>47,208.6</td>
<td>29,467.5</td>
<td>62.4</td>
<td>33,500.0</td>
<td>69.2</td>
</tr>
<tr>
<td>First Union Realty</td>
<td>10-31-65</td>
<td>43,418.5</td>
<td>42,341.1</td>
<td>23,253.8</td>
<td>54.9</td>
<td>23,966.5</td>
<td>55.2</td>
</tr>
<tr>
<td>National Realty</td>
<td>9-30-65</td>
<td>29,662.7</td>
<td>27,326.4</td>
<td>17,001.8</td>
<td>62.2</td>
<td>17,563.7</td>
<td>59.5</td>
</tr>
<tr>
<td>Franklin Realty</td>
<td>6-30-65</td>
<td>24,833.9</td>
<td>24,222.2</td>
<td>16,859.0</td>
<td>69.6</td>
<td>18,087.9</td>
<td>72.7</td>
</tr>
<tr>
<td>American Realty</td>
<td>9-30-65</td>
<td>22,610.0</td>
<td>22,146.6</td>
<td>12,422.7</td>
<td>56.1</td>
<td>16,328.7</td>
<td>72.2</td>
</tr>
<tr>
<td>Columbia REIT</td>
<td>12-31-65</td>
<td>21,132.0</td>
<td>19,726.8</td>
<td>17,275.9</td>
<td>87.5</td>
<td>18,401.9</td>
<td>87.1</td>
</tr>
<tr>
<td>Greenfield REIT</td>
<td>10-31-65</td>
<td>17,918.7</td>
<td>15,996.7</td>
<td>9,069.3</td>
<td>56.7</td>
<td>9,279.4</td>
<td>51.8</td>
</tr>
<tr>
<td>Flato Realty</td>
<td>6-30-64</td>
<td>11,633.8</td>
<td>11,259.5</td>
<td>7,211.2</td>
<td>64.0</td>
<td>7,920.1</td>
<td>68.1</td>
</tr>
<tr>
<td>Commonwealth Realty</td>
<td>11-30-65</td>
<td>9,113.9</td>
<td>8,032.3</td>
<td>4,988.3</td>
<td>62.1</td>
<td>5,151.2</td>
<td>56.5</td>
</tr>
<tr>
<td><strong>&quot;Combination Trusts&quot;</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pennsylvania REIT</td>
<td>6-30-65</td>
<td>44,553.6</td>
<td>40,724.8</td>
<td>30,429.0</td>
<td>74.7</td>
<td>38,718.7</td>
<td>86.9</td>
</tr>
<tr>
<td>Prudential REIT of America</td>
<td>10-30-65</td>
<td>37,125.2</td>
<td>35,843.5</td>
<td>9,676.1</td>
<td>27.0</td>
<td>10,037.1</td>
<td>27.0</td>
</tr>
<tr>
<td>Liberty</td>
<td>10-30-65</td>
<td>28,449.6</td>
<td>21,110.1</td>
<td>18,666.0</td>
<td>78.9</td>
<td>24,059.6</td>
<td>84.4</td>
</tr>
<tr>
<td>Liberty</td>
<td>12-30-64</td>
<td>17,499.3</td>
<td>16,381.1</td>
<td>8,854.3</td>
<td>54.1</td>
<td>10,851.5</td>
<td>62.0</td>
</tr>
<tr>
<td>Sixty</td>
<td>4-30-65</td>
<td>17,108.3</td>
<td>14,124.3</td>
<td>3,285.2</td>
<td>22.8</td>
<td>9,847.8</td>
<td>57.6</td>
</tr>
<tr>
<td>Denver</td>
<td>12-31-65</td>
<td>15,110.2</td>
<td>14,262.3</td>
<td>6,252.1</td>
<td>43.8</td>
<td>7,795.1</td>
<td>51.6</td>
</tr>
<tr>
<td>Bradley</td>
<td>8-31-65</td>
<td>11,921.5</td>
<td>8,652.7</td>
<td>5,513.0</td>
<td>63.7</td>
<td>6,626.8</td>
<td>55.6</td>
</tr>
<tr>
<td><strong>Mortgage Trusts</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Continental</td>
<td>3-31-65</td>
<td>76,669.1</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>51,500.3</td>
<td>67.2</td>
</tr>
<tr>
<td>First Mortgage</td>
<td>1-31-65</td>
<td>68,979.1</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>54,203.2</td>
<td>78.6</td>
</tr>
<tr>
<td>Southeastern</td>
<td>9-30-65</td>
<td>22,746.6</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>13,950.6</td>
<td>61.3</td>
</tr>
</tbody>
</table>

Source:

feel their first duty is to enhance the underlying worth of their shareholders' investment. In an earlier year, for example, the trust reduced its mortgage debt by over $500,000 while using the balance of its $712,000 in depreciation on improvements and additions to its existing property.  

Heaviest of the borrowers is Park Ave REIT. Its one parcel of property with a cost of $7.2 million is encumbered with a $7 million mortgage. This gives the trust an equity ratio of just three per cent. The trust does meet state "blue sky" laws because an independent appraisal of its building set a value of $11 million.  

DEPRECIATION

In selecting a method of depreciation to be adopted trustees must keep two considerations in mind:

1. The possibility of supplementing distributions from income with payments out of excess depreciation.

2. The effect of the depreciation policy on cash flow.

Some trusts choose to pay out dividends in excess of trust earnings. The additional funds come from cash generated through excess depreciation. That part of the dividend not actually earned is viewed as a return of capital and is a tax-free distribution to the investor. The shareholder in effect receives a dividend which is "sheltered"

---

58 Elliot, April 5, 1965, op. cit., pp. 5-6

59 Midwestern and Western states require at least a one-third equity position based on appraisal value in order to qualify a security in the state.
from taxes. This particular consideration is discussed later in this section. The first portion of this section examines the depreciation-cash flow relationship.

The method of depreciation adopted by a trust will affect its cash flow over both the short and long run. Depreciation reduces income in the accounting sense and is a deduction for income tax purposes. But unlike interest payments, depreciation is unique because it does not represent a current cash expenditure. A decrease in depreciation charges will increase income and therefore increase cash demands on the trust for taxes and dividends which must be paid.

Two methods of depreciation are available to the trust—straight-line and accelerated depreciation. Graphically, the cash demand under straight-line depreciation looks as follows:

FIGURE II
STRAIGHT-LINE DEPRECIATION
AND CASH DEMANDS

CASH

TAXES AND DIVIDENDS

DEPRECIATION

TIME

At the same time under the accelerated method of depreciation cash demands for taxes and dividends will appear as shown in Figure III.

FIGURE III
ACCELERATED DEPRECIATION
CASH DEMANDS

Source: See Figure II.

Since the total depreciation deduction is the same under either method, it is obvious—as the above graphs show—that accelerated depreciation simply uses future depreciation charges to reduce taxes and dividend payments during the early years. The cash payments will have to be repaid in later years.

The danger in the accelerated method—and one of the considerations facing trusts when choosing a depreciation method—is that the trust management will fail to recognize that the availability of cash in the early years will be offset by a necessity for additional cash in later years. The pressure of the market may cause the trust to distribute the excess cash in the early years and leave insufficient
funds for future distributions. By adhering to the straight-line concept in its distribution to shareholders, the trustees can better provide for the availability of cash for future requirements.\textsuperscript{60}

Returning to the first consideration mentioned—the possibility of paying dividends out of depreciation-generated cash—it is apparent from Table V that a number of trusts follow this practice. The three mortgage trusts in the table are not concerned with depreciation and therefore pay dividends out of income resulting from normal mortgage transactions. However, of the other 17 trusts, nine have made distributions which are partially paid out of cash generated from depreciation charges. In one instance a trust has paid a dividend despite the fact that it had a net loss. These dividend payments from cash accumulated through depreciation charges represent a tax-free return of capital to the investor.

\textbf{DIVIDENDS}

History has shown that trusts also have varied in the return paid to investors. Table VI points out that over the years almost all of the trusts have been able to make some distribution to their investors. Some, though, have been more rewarding than others.

Table VI compares the earnings and distributions of selected trusts from 1962 to 1965. It indicates that more than half of the trusts listed have experienced a continual increase in earnings over the four year period. During the same years every one of the trusts

\textsuperscript{60} Irving M. Grant and John E. Scheifly, \textit{op. cit.}, p. 245.
### TABLE V

CASH FLOWS AND CASH DISTRIBUTIONS
OF SELECTED REAL ESTATE INVESTMENT TRUSTS
In thousands of dollars

<table>
<thead>
<tr>
<th>TRUST</th>
<th>Fiscal Year Ended</th>
<th>Net Income (Loss)</th>
<th>Predepreciation Earnings</th>
<th>Debt Principal Payments</th>
<th>Net Cash Flow</th>
<th>Distributions Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Continental</td>
<td>3-31-65</td>
<td>$2,618.9</td>
<td>$2,618.9</td>
<td>$ -</td>
<td>$2,618.9</td>
<td>$2,548.9</td>
</tr>
<tr>
<td>First Mortgage</td>
<td>1-31-65</td>
<td>1,151.2</td>
<td>1,151.2</td>
<td>-</td>
<td>1,151.2</td>
<td>1,161.1</td>
</tr>
<tr>
<td>U.S. Realty</td>
<td>12-31-64</td>
<td>45.9</td>
<td>1,733.7</td>
<td>-</td>
<td>1,733.7</td>
<td>913.1</td>
</tr>
<tr>
<td>First National REIT</td>
<td>12-31-65</td>
<td>955.1</td>
<td>2,245.0</td>
<td>-</td>
<td>2,245.0</td>
<td>1,390.1</td>
</tr>
<tr>
<td>National Realty</td>
<td>9-30-65A</td>
<td>467.2</td>
<td>1,112.8</td>
<td>-</td>
<td>1,112.8</td>
<td>504.0</td>
</tr>
<tr>
<td>Pennsylvania REIT</td>
<td>6-30-65</td>
<td>370.1</td>
<td>1,520.8</td>
<td>637.6</td>
<td>883.2</td>
<td>370.1</td>
</tr>
<tr>
<td>First Union Realty</td>
<td>10-30-65</td>
<td>606.4</td>
<td>1,997.2</td>
<td>-</td>
<td>1,997.2</td>
<td>606.4</td>
</tr>
<tr>
<td>R.E.I.T. of America</td>
<td>11-30-65</td>
<td>1,595.4</td>
<td>2,304.7</td>
<td>-</td>
<td>2,304.7</td>
<td>1,757.9</td>
</tr>
<tr>
<td>Prudential</td>
<td>11-30-65</td>
<td>272.0</td>
<td>1,347.1</td>
<td>-</td>
<td>1,347.1</td>
<td>272.0</td>
</tr>
<tr>
<td>Franklin Realty</td>
<td>6-30-65</td>
<td>380.1</td>
<td>951.5</td>
<td>-</td>
<td>951.5</td>
<td>366.0</td>
</tr>
<tr>
<td>Southeastern</td>
<td>9-31-65</td>
<td>632.9</td>
<td>632.9</td>
<td>-</td>
<td>632.9</td>
<td>560.0</td>
</tr>
<tr>
<td>American Realty</td>
<td>9-30-65</td>
<td>158.5</td>
<td>793.0</td>
<td>-</td>
<td>793.0</td>
<td>692.2</td>
</tr>
<tr>
<td>Columbia REIT</td>
<td>12-31-65</td>
<td>(15.7)</td>
<td>540.2</td>
<td>251.6</td>
<td>288.6</td>
<td>604.6</td>
</tr>
<tr>
<td>Greenfield REIT</td>
<td>10-31-65</td>
<td>361.7</td>
<td>912.1</td>
<td>-</td>
<td>912.1</td>
<td>361.7</td>
</tr>
<tr>
<td>Liberty</td>
<td>12-31-64</td>
<td>298.6</td>
<td>752.9</td>
<td>-</td>
<td>752.9</td>
<td>-0-</td>
</tr>
<tr>
<td>Sixty</td>
<td>4-30-65</td>
<td>1,010.3</td>
<td>1,196.8</td>
<td>-</td>
<td>1,196.8</td>
<td>821.2</td>
</tr>
<tr>
<td>Denver</td>
<td>12-31-65</td>
<td>395.7</td>
<td>766.9</td>
<td>397.1</td>
<td>379.3</td>
<td>400.0</td>
</tr>
<tr>
<td>Bradley</td>
<td>8-31-65</td>
<td>303.1</td>
<td>931.7</td>
<td>-</td>
<td>931.7</td>
<td>-0-</td>
</tr>
<tr>
<td>Flato Realty</td>
<td>6-30-64</td>
<td>(41.0)</td>
<td>235.7</td>
<td>-</td>
<td>235.7</td>
<td>-0-</td>
</tr>
<tr>
<td>Commonwealth REIT</td>
<td>12-30-65</td>
<td>127.6</td>
<td>345.2</td>
<td>-</td>
<td>345.2</td>
<td>258.3</td>
</tr>
</tbody>
</table>

A-9 months ended

Source:
other than Flato Realty has made some dividend distribution to its shareholders. And 18 of the 20 trusts have gradually increased their dividends.

The mortgage trusts listed on Table VI have shown the strongest growth both in earnings and in distributions. During the four years, Continental Mortgage Trust's dividend has increased six-fold. Even more impressive is First Mortgage Investor, whose dividend has doubled and whose earnings have increased from $.04 in 1962 to $1.13 per share in 1965. At the same time the younger Southeastern Mortgage Trust appears to be experiencing the same successful growth.

Growth has varied somewhat among the property-holding trusts. Some trusts like REIT of America have shown a steady and strong growth while others, like Flato Realty, have found profit a difficult goal to attain. Overall, it appears that real estate investment trusts can be characterized as having a slow, gradual growth.

The difference in the return paid to investors can, of course, be attributed to many factors. Surely, the primary factor is the ability of the trust's property to earn an income. A second major factor is the policy of the trustees in regard to whether funds generated by depreciation should be distributed or reinvested.

Some REITs follow a policy of distributing only earnings. Funds accumulated through amortization and depreciation charges are retained in the trust. Both REITA and Franklin Realty distribute only earnings.

Franklin's President, Harold Gebert, sums up this philosophy
<table>
<thead>
<tr>
<th>TRUST</th>
<th>62</th>
<th>63</th>
<th>64</th>
<th>65</th>
<th>Tot.</th>
<th>62</th>
<th>63</th>
<th>64</th>
<th>65</th>
<th>Tot.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Trusts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. Realty Investments</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>.70</td>
<td>.70</td>
<td>.74</td>
<td>.74</td>
<td>2.88</td>
</tr>
<tr>
<td>First National REIT</td>
<td>.11</td>
<td>.20</td>
<td>.43</td>
<td>.52</td>
<td>1.26</td>
<td>.16</td>
<td>.76</td>
<td>.73</td>
<td>.77D</td>
<td>2.42</td>
</tr>
<tr>
<td>National Realty</td>
<td>.08</td>
<td>.34</td>
<td>.41</td>
<td>.52</td>
<td>1.35</td>
<td>.08</td>
<td>.53</td>
<td>.68</td>
<td>.81</td>
<td>2.10</td>
</tr>
<tr>
<td>First Union Realty</td>
<td>.21</td>
<td>.23</td>
<td>.31</td>
<td>.31</td>
<td>1.06</td>
<td>.70</td>
<td>.76</td>
<td>.78D</td>
<td>.78D</td>
<td>3.02</td>
</tr>
<tr>
<td>Franklin Realty</td>
<td>.01</td>
<td>.22</td>
<td>.47</td>
<td>.62</td>
<td>1.32</td>
<td>.09</td>
<td>.32</td>
<td>.57</td>
<td>.62</td>
<td>1.60</td>
</tr>
<tr>
<td>American Realty</td>
<td>.23</td>
<td>.27</td>
<td>.23</td>
<td>.16</td>
<td>.89</td>
<td>.47</td>
<td>.54</td>
<td>.72</td>
<td>.72</td>
<td>2.45</td>
</tr>
<tr>
<td>Columbia REIT</td>
<td>-0-</td>
<td>-0-</td>
<td>1.45</td>
<td>1.14</td>
<td>2.59</td>
<td>-0-</td>
<td>.45</td>
<td>.60</td>
<td>.60</td>
<td>1.65</td>
</tr>
<tr>
<td>Greenfield REIT</td>
<td>.30</td>
<td>.38</td>
<td>.76</td>
<td>.73</td>
<td>2.17</td>
<td>.45</td>
<td>.88</td>
<td>.95</td>
<td>1.00</td>
<td>3.28</td>
</tr>
<tr>
<td>Flato Realty</td>
<td>E</td>
<td>0.4F</td>
<td>-0-</td>
<td>N/A</td>
<td>.04</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Commonwealth REIT</td>
<td>.20</td>
<td>.35</td>
<td>.28</td>
<td>.30</td>
<td>1.13</td>
<td>.21</td>
<td>.59</td>
<td>.60</td>
<td>.60</td>
<td>2.00</td>
</tr>
<tr>
<td>Mixed Trusts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pennsylvania REIT</td>
<td>.15</td>
<td>.55</td>
<td>.50</td>
<td>.49</td>
<td>1.69</td>
<td>.20</td>
<td>.80</td>
<td>.80</td>
<td>.80D</td>
<td>2.60</td>
</tr>
<tr>
<td>R.E.I.T. of America</td>
<td>1.16</td>
<td>1.21</td>
<td>1.24</td>
<td>1.24</td>
<td>4.85</td>
<td>1.20</td>
<td>1.20</td>
<td>1.20</td>
<td>1.37</td>
<td>4.97</td>
</tr>
<tr>
<td>Prudential</td>
<td>E</td>
<td>E</td>
<td>E</td>
<td>.39</td>
<td>.39</td>
<td>E</td>
<td>E</td>
<td>.23</td>
<td>1.04</td>
<td>1.27</td>
</tr>
<tr>
<td>Liberty</td>
<td>.43</td>
<td>.17</td>
<td>.17</td>
<td>.31</td>
<td>1.08</td>
<td>.65</td>
<td>.72</td>
<td>.15</td>
<td>-0--</td>
<td>1.57</td>
</tr>
<tr>
<td>Sixty</td>
<td>N/A</td>
<td>N/A</td>
<td>128.88</td>
<td>160.37</td>
<td>289.25</td>
<td>N/A</td>
<td>N/A</td>
<td>90.63</td>
<td>130.36</td>
<td>220.99</td>
</tr>
<tr>
<td>Denver</td>
<td>.40</td>
<td>.46</td>
<td>.45</td>
<td>.49</td>
<td>1.80</td>
<td>.39</td>
<td>.48</td>
<td>.50</td>
<td>.50D</td>
<td>1.87</td>
</tr>
<tr>
<td>Bradley</td>
<td>N/A</td>
<td>.36</td>
<td>N/A</td>
<td>.31</td>
<td>.67</td>
<td>N/A</td>
<td>N/A</td>
<td>.25</td>
<td>.25</td>
<td>.61</td>
</tr>
<tr>
<td>Mortgage Trusts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Continental</td>
<td>.18G</td>
<td>.77</td>
<td>1.14</td>
<td>1.45</td>
<td>3.54</td>
<td>.26</td>
<td>.91</td>
<td>1.24</td>
<td>1.59D</td>
<td>4.00</td>
</tr>
<tr>
<td>First Mortgage Investors</td>
<td>.04</td>
<td>.60</td>
<td>.85</td>
<td>1.03</td>
<td>2.85</td>
<td>.59</td>
<td>.78</td>
<td>1.04</td>
<td>1.13D</td>
<td>3.54</td>
</tr>
<tr>
<td>Southeastern</td>
<td>E</td>
<td>E</td>
<td>.40H</td>
<td>.63H</td>
<td>1.03</td>
<td>E</td>
<td>E</td>
<td>.72</td>
<td>.77D</td>
<td>1.49</td>
</tr>
</tbody>
</table>

A—Fiscal year; B—Calendar year; C—Trust operates under the net loss theory of accounting wherein depreciation offsets income; D—Dividend not eligible for tax exclusion; E—not established as a REIT; F—For eight months ended 6-30-63; G—three months ended 12-31-62, change in fiscal year; H—nine months ended 9-30.

Source:
Handbook of Member Trusts, National Association of Real Estate Investment Funds.
in these words: "If the shareholder wants his money back, he will sell his stock."\(^{61}\)

At the other end of the distribution philosophy lies U.S. Realty, biggest of the equity trusts. The U.S. Realty dividend is wholly a tax-sheltered return of capital—it's covered by no earnings at all. Although in 1964, the trust generated a cash flow of $1.7 million, it ended the year with a net loss of $3366. This was the result of a write-off in depreciation of more than was earned. Trustee Sheldon Guren commented: "That is what I call beautiful, precision accounting."\(^{62}\)

The majority of REITs follow a middle road in their dividend payment policy. Their distribution is both a return on capital and a return of capital. The Cleveland based First Union Realty, for instance, has elected to take accelerated depreciation on only one piece of property in order to pay a return which is more than one-half accounted for by cash flow rather than earnings. Other trusts follow different policies which yield different relationships between the return of capital and the return on capital (See Table VII).

A second picture of the relative size of the return paid by selected trusts is presented by Table VII. This table looks from the viewpoint of percentage return on issue price and market price.

The return paid varies among the listed trusts. Generally, it lies between five and eight per cent on original issue price. A

---


### TABLE VII

**DISTRIBUTIONS PAID BY SELECTED REAL ESTATE INVESTMENT TRUSTS**

<table>
<thead>
<tr>
<th>TRUST</th>
<th>Orig. Issue</th>
<th>8-31-66 Price</th>
<th>G.T.C.</th>
<th>1965 Distributions(^B)</th>
<th>Yield on Cap. of</th>
<th>Yield on Total Issue</th>
<th>Bid</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Realty</td>
<td>$10.00</td>
<td>10.75</td>
<td>-.0-</td>
<td>.74</td>
<td>.74</td>
<td>7.4%</td>
<td>6.9</td>
</tr>
<tr>
<td>East National REIT</td>
<td>10.00</td>
<td>8.75</td>
<td>.77</td>
<td>-.0-</td>
<td>.77</td>
<td>7.7%</td>
<td>8.8</td>
</tr>
<tr>
<td>National Realty</td>
<td>15.00</td>
<td>9.38</td>
<td>.81</td>
<td>-.0-</td>
<td>.81</td>
<td>5.4%</td>
<td>8.6</td>
</tr>
<tr>
<td>First Union Realty</td>
<td>12.50</td>
<td>10.00</td>
<td>.31</td>
<td>.47</td>
<td>.78</td>
<td>6.2%</td>
<td>7.8</td>
</tr>
<tr>
<td>Franklin Realty</td>
<td>12.50</td>
<td>8.50</td>
<td>.62</td>
<td>-.0-</td>
<td>.62</td>
<td>4.9%</td>
<td>5.7</td>
</tr>
<tr>
<td>American Realty</td>
<td>10.00</td>
<td>6.75</td>
<td>.16</td>
<td>.56</td>
<td>.72</td>
<td>7.2%</td>
<td>10.7</td>
</tr>
<tr>
<td>Columbia REIT</td>
<td>10.00</td>
<td>13.75</td>
<td>-.0-</td>
<td>.60</td>
<td>.60</td>
<td>6.0%</td>
<td>4.4</td>
</tr>
<tr>
<td>Greenfield REIT</td>
<td>20.00</td>
<td>14.75</td>
<td>1.00</td>
<td>-.0-</td>
<td>1.00</td>
<td>5.0%</td>
<td>6.9</td>
</tr>
<tr>
<td>Flato Realty</td>
<td>10.00</td>
<td>N/A</td>
<td>-.0-</td>
<td>-.0-</td>
<td>-.0-</td>
<td>-.0-</td>
<td>-.0-</td>
</tr>
<tr>
<td>Commonwealth REIT</td>
<td>10.00</td>
<td>4.00</td>
<td>-.0-</td>
<td>.60</td>
<td>.60</td>
<td>6.0%</td>
<td>15.0</td>
</tr>
</tbody>
</table>

**COMBINATION TRUSTS**

| REIT of America | 10.00       | 10.00       | .29   | .51                        | .80              | 8.0%                 | 8.0 |
| Prudential      | 20.00       | 17.38       | 1.21\(^D\) | .16   | 1.37                        | 6.9%                 | 7.9 |
| Liberty         | N/A         | 12.00       | 1.04  | -.0-                       | 1.04             | -.0-                 | 8.6 |
| Sixty           | 10.00       | 2.00        | -.0-  | -.0-                       | -.0-             | -.0-                 | -.0-|
| Denver          | 1000.00     | 2000.00     | 130.36 | -.0-                       | 130.36           | 13.0%                | 6.5 |
| Bradley         | 10.00       | 9.00        | .50   | -.0-                       | .50              | 5.0%                 | 5.5 |

**MORTGAGE TRUSTS**

| Continental     | 15.00       | 27.82       | 1.59  | -.0-                       | 1.59             | 10.6%                | 5.9 |
| First Mortgage  | 15.00       | 12.50       | 1.13  | -.0-                       | 1.13             | 7.5%                 | 9.0 |
| Southeastern    | 10.00       | 7.50        | .77   | -.0-                       | .77              | 7.7%                 | 10.2|

\(A\)-Over-the-counter bid price; \(B\)-Calendar year; \(C\)-Consolidation of predecessor trusts; \(N/A\)-Not available; \(D\)-.17 is taxable as capital gain.

Source:


*Handbook of Member Trust*, National Association of Real Estate Funds.
slightly higher return results when the yield is computed on market bid price.

As a group the mortgage trusts show a slightly more favorable return. These trusts have been paying a six to ten per cent return and over seven per cent on their original issue price. The other trusts, as noted, are paying various rates of return. Each distribution is undoubtedly a reflection of the property, management, and policies of the individual trust.
CHAPTER VI

CONCLUSIONS AND SUMMARY

CONCLUSIONS

After an evaluation of the history, organization, and operations of Real Estate Investment Trusts, it is submitted that trust legislation and operating characteristics are deficient in certain respects and that REITs, as they have evolved to date, have not achieved the goal set for them by Congress. This final chapter presents specific conclusions and recommendations drawn from the study. These conclusions include both noted legislative problems, and findings drawn from operational analyses.

**Legislative Deficiencies**

**Corporate Status**

A serious deficiency of the REIT legislation is the failure to allow corporations to qualify for beneficial tax treatment. As presently constituted, the law permits only unincorporated associations to qualify as real estate investment trusts. There appears to be no purpose behind excluding corporations other than for revenue reasons—the collection of taxes. The requirement that the trust form of organization be used is cumbersome and makes it questionable whether the desired real estate investment vehicle can be created under the trust laws of many states.

Congress desired that the real estate market have an investment vehicle similar to the regulated investment company. Just as the
latter was not restricted to a particular form of organization, so should the real estate investment vehicle have more leeway in adopting an organizational form.

Recognizing this situation, certain members of Congress introduced House of Representatives Bill 4620 on February 1, 1966, to the Congress of the United States. This bill would amend the 1954 Code to permit corporations to qualify as REITs after 12-31-64. The bill was passed by the House on October 10, 1966, and is presently before the Senate Finance Committee. The passage of this bill is a vital and necessary link in the further development of Real Estate Investment Trusts.

Trustee Management

Another major handicap confronting trusts is the REIT legislation requirement that trustees must exercise exclusive authority over the trust, but they themselves cannot manage the trust's properties. This property management must be delegated to an independent contractor. A trust which provides other than customary landlord services to its tenants faces possible loss of its favored status. The apparent purpose of the regulation is to restrict the amount of income from active operation of real property—as compared to passive investment—which would be permitted to escape corporate taxation.

As written, the regulations present a question of interpretation. It is not clear just how far Congress intended to limit a trust's activities. At the same time, the regulations which require an "arm's length" relationship between trustee and independent contractor fall
to define exactly an "independent contractor." The Congressional desire to limit income derived from active real estate management has resulted in strict regulations which have seriously hindered the formation and operations of trusts.

The REIT law should be expanded to provide a more complete description of the relationship between the trustee and independent contractor. Furthermore, the existing law should be reviewed both as to its effectiveness and necessity in restricting active property management, and to the desirability of narrowly defining the trustee's duties. All this should be done in light of the motivating Congressional desire to create a real estate investment vehicle patterned after the regulated investment company.

Disqualification

A third noted weakness of the REIT regulations is the provision which can impose immediate disqualification upon a trust or effect retroactive recession of its favored tax status. A trust labors under undue hardship when it must face sudden disqualification if the ownership, investment, or other requirements are breached—especially since the unlawful action can occur totally independent of the trust's management. It is conceivable, for instance, that a trust is in violation of the regulations because trading of its certificates has resulted in a prohibited share distribution. Some provision should be made to absolve an innocent trust from guilt and preclude the necessity of facing disqualification if the violation occurred through no fault of the trust.
The penalty of disqualification is made even more severe when it is imposed retroactively. A trust acting under a good-faith determination of taxable income has been distributing at least ninety per cent of its adjusted income over the years. Suddenly, if retroactively disqualified, the trust finds itself required to pay a 52 per cent corporate tax on a prior year's (or years') income while its liquid assets are at a minimum. The trust regulations should be so amended to provide that in the event of a subsequent determination a prior year's REIT taxable income has been understated, the trust may distribute a deficiency dividend equal to at least 90 per cent of its additional income.

Operational Deficiencies

The statistics and analysis presented in this thesis indicate that trusts have failed to achieve the status envisioned by Congress. This section of the chapter presents conclusions regarding the operations of trusts which have been drawn from the analysis.

Diversification

Congress envisioned the real estate trust as being an instrument through which the small investor could invest in a portfolio of diversified property. An examination of Table III reveals that most trusts have achieved only limited diversification in a number of areas--number of shareholders, units of property, types of property, and geographical location.

Of the 16 trusts listed in Table III for which statistics are
available, not one trust has more than 8500 shareholders, and only three can claim more than 5000 shareholders. Twenty-five per cent of these trusts have fewer than 500 holders of beneficial shares.

Why have the trusts failed to gain widespread ownership and acceptance? A number of reasons appear to exist. First, the trusts are still relatively new. The investor-public has little precedent upon which to judge and make a decision. There is hesitance to put funds into a new, untested vehicle. Second, real property is of such a nature that investors are uncertain as to its investment value. Often, the average investor is not capable of adequately judging the profit-making potential of a single piece of property much less that of a group of properties making up a trust's portfolio. Finally, some trusts possibly have only a few shareholders by design. It is possible for trusts to meet the requirements of the law, yet leave overall control in the hands of a selected few.

Once again, a cursory examination of Table III further reveals only limited diversification in the number and type of property held, and the geographical location of the trust property itself. A majority of the property-owning trusts included in Table III own fewer than 20 units of real estate, and the bulk of this property consists of office buildings and apartments. Normally, trust managers limit investment to that type of property with which they are most familiar. At the same time it is apparent that most trusts have chosen to keep geographic diversification of property locations to a minimum. Table III shows that only three of the 17 trusts hold property located in 10 or more states. In retrospect it appears that the Congressional desire
to create a diversified real estate investment vehicle has met with only limited realization.

Profitability

Historically, real estate trusts have performed poorly as far as profitability is concerned. During their early years few trusts have achieved a consistent growth in earnings.

The most impressive growth—as shown by Table VI—has occurred among the mortgage trusts. All three of the mortgage-holding trusts included in the table have experienced a consistent and fairly substantial increase in earnings during the years 1962 through 1965.

Those trusts listed which hold real property have not fared quite as well. Of the 11 equity trusts which have reported yearly earnings from 1962 to 1965, only three have experienced a constant increase in earnings. The other trusts have reported irregular or only fairly stable earnings.

A number of factors undoubtedly have contributed to the low earnings. As noted earlier, many trusts in their early, formative years had difficulty in finding good investment property. During their search for property the trusts put unused funds into low-interest government securities, and as a result earnings were modest. It can be assumed as more funds are channeled into more profitable investments, trust earnings should rise.

Some trusts have low earnings by design. Desiring to pay out a dividend which is a "return of capital" certain trusts have intentionally understated earnings through the use of accelerated depre-
Finally, some poor showings can be attributed to the poor choice of investments made by the trustees. The earnings of the trust are simply a reflection of the investment ability of the trustees.
SUMMARY

A real estate investment trust is an unincorporated trust or association which meets certain organizational, income, and investment requirements prescribed in the Revenue Code and Treasury regulations. Ownership of the trust must be evidenced by transferable shares of beneficial interest held by at least one hundred individuals. No more than 50 per cent of the value of the trust's outstanding stock may be owned by five or fewer shareholders.

The income requirements state that 90 per cent of the trust's income must come from certain designated sources. Furthermore, 75 per cent of the trust's income must come in some way entirely from real property interests.

The investment requirements prescribe the specific type and degree of holdings which must be included in the trust's portfolio. The bulk of these assets must be in the form of real property interests, cash, cash items, or government securities. Treasury regulations require that the trustees revalue the trust's assets each quarter to apply the two tests.

If a trust meets the above requirements and elects to be taxed as a "qualified" REIT, it would be taxed as follows:

1. If the trust distributes all of its taxable income, it faces no tax liability.

2. If it distributes at least 90 per cent of its income, it will pay a tax on its undistributed profits at the ordinary corporate tax rates.
3. Should the trust fail to pay out 90 per cent of its income, its entire earnings will be taxed at the corporate rate.

The two primary kinds of trusts are mortgage trusts and equity trusts. Equity trusts use their funds to purchase fee ownership and leaseholds in real property. These can be further classified into the following five groups: "blank check" trusts, exchange or swap trusts, purchase trusts, mixed trusts, and existing trusts. The second major class of trusts, mortgage trusts, operates under a policy of acquiring mortgages encumbering real property rather than the property itself.

Trusts have different policies regarding the manner in which they operate. Some trusts minimize debt while others seek a high degree of leverage. The type and location of property interests also vary among the trusts. Certain trusts use straight-line depreciation while others use accelerated depreciation to increase the flow of "dividend-available" cash. Dividends paid by trusts—depending on their policies—may be a return on capital, a return of capital, or a combination of both.

In their short lives real estate investment trusts have shown both promise and disappointment. Some trusts have performed admirably while others have found profit a hard goal to attain. Many have found the legislation which brought them into being to be deficient in many ways. Congress must review trust legislation in light of the purpose behind its enactment and in light of the trusts' performance to date.
BIBLIOGRAPHY

BOOKS


ARTICLES IN SPECIAL WORKS


PERIODICALS


Stone, Leo D. "Real Estate Investment Trusts: Their Experience and Prospects," Bulletin of Business Research, Columbus, Ohio: Bureau of Business Research, Division of Research, College of Commerce and Administration, The Ohio State University, (January, 1966), 8-9.


PARTS OF SERIES


GOVERNMENT PUBLICATIONS
