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The Real Estate Investment Trust: State Tax, Tort, and Contract Liabilities of the Trust, Trustee, and Shareholder

In 1960, after lying dormant for almost twenty-five years, the business trust suddenly became a subject of great interest as a result of the addition of the Real Estate Investment Trust Act to the Internal Revenue Code. Under the Act, a Real Estate Investment Trust (REIT), which is basically a business trust that meets certain specified qualifications, does not have to pay any federal tax on the portion of its capital gains and ordinary income that it distributes to its shareholders during or with respect to the taxable year.

Since the passage of the Act, as could be expected, there have been a large number of REITs formed, and a great number of articles written about them. However, almost all of these articles

1. This period of dormancy began with the landmark case of Morrissey v. Commissioner, 296 U.S. 344 (1935), in which the Supreme Court held that Massachusetts trusts were taxable as corporations, changing the earlier rule expressed in Crocker v. Malley, 249 U.S. 223 (1919).

2. Also known as a common-law trust or Massachusetts trust, defined by the Supreme Court as a form of business organization, common in that State [Massachusetts], consisting essentially of an arrangement whereby property is conveyed to trustees, in accordance with the terms of an instrument of trust, to be held and managed for the benefit of such persons as may from time to time be the holders of transferable certificates issued by the trustees showing the shares into which the beneficial interest property is divided. Hecht v. Malley, 265 U.S. 144, 146-47 (1924).


4. INT. REV. CODE OF 1954, §§ 856(a), 856(c), 857(a). See text accompanying notes 10-21 infra.

5. INT. REV. CODE OF 1954, § 857(b).


have dealt with the federal tax aspects of REITs; only a few have investigated problems encountered in dealing with state statutes and case law on business trusts. The current posture of state law in this area is confused despite the passage of twelve years since the adoption of the Real Estate Investment Trust Act. Indeed, it has been noted that many investors are reluctant to purchase REIT shares because they believe that investment in a REIT entails the assumption of liabilities under state law—particularly for debts and torts of the REIT—to a greater extent than investment in a corporation.

This Comment will attempt to alert potential investors in and trustees of REITs to the full extent of the liabilities that they could suffer for contract debts incurred in the name of the trust and torts committed by trust personnel. Since state tax considerations also play a significant role in investment decisions, the manner in which each state taxes the REIT and its shareholders on income derived from property and business in that state will also be investigated. Finally, a rational path out of the morass created by current state law will be articulated in order to prompt renewed discussion in Congress and in the state legislatures and courts on a cogent policy for dealing with the liabilities of the REIT, its trustees, and its shareholders.

I. GENERAL BACKGROUND

To obtain the special tax treatment afforded by the Real Estate Investment Trust Act, a business must fulfill a number of qualifications. It must be an unincorporated trust or unincorporated association, be managed by one or more trustees, have its beneficial ownership evidenced by transferable shares, be the type of entity that would ordinarily be taxable as a domestic corporation but for the REIT provisions of the Code, and be owned by at least one hundred persons. It cannot be a business that would be a personal holding company if all of its adjusted ordinary gross in-

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8. E.g., Jones, supra note 7; Weissman, 38 CHIL.-KENT L. REV. 11, supra note 7; Weissman, 49 ILL. B.J. 744, supra note 7; Note, 24 ARK. L. REV. 453, supra note 7; Note, 48 VA. L. REV. 1105, supra note 7.
10. INT. REV. CODE OF 1954, § 856(a).
come were personal holding company income, and it cannot hold any property primarily for sale to customers in the ordinary course of its trade or business. It must distribute to its shareholders at least ninety per cent of its taxable ordinary income.

In addition, a business entity must meet certain requirements as to sources of income and diversification of assets in each taxable year in which it seeks to qualify as a REIT. It must derive: 1) at least ninety per cent of its gross income from dividends, interest, rents from real property, gain from the sale or other disposition of stock, securities, and real property (including interests in real property), and abatements and refunds of real property taxes; 2) at least seventy-five per cent of its gross income from its passive real estate investments and from abatements and refunds on real property; 3) less than thirty per cent of its gross income from the sum of its short-term capital gains on stock or securities and its gains from the sale of real property held less than four years. At the close of each quarter of its taxable year, at least seventy-five per cent of its total assets must be represented by real estate assets, cash, and government securities, with the remaining twenty-five per cent, if invested in securities, limited to not more than ten per cent of the outstanding voting securities of any one issuer.

If an entity can meet all these qualifications, it can serve, in essence, as a conduit, with its distributed income taxed only once—when it gets into the hands of its shareholders. As something of a quid pro quo, shareholders may not treat any distributions of ordinary income from the REIT as dividends for purposes of the one hundred dollar dividends-received exclusion or the eighty-five per cent dividends-received deduction applicable to corporate shareholders.

15. INT. REV. CODE OF 1954, § 856(a)(6). “Adjusted ordinary gross income” is defined by section 549(b)(2).
18. INT. REV. CODE OF 1954, § 856(c)(2).
19. INT. REV. CODE OF 1954, § 856(c)(3).
21. INT. REV. CODE OF 1954, § 856(c)(5).
22. It is obvious that to someone who prefers investments in entities that distribute a large proportion of their income this conduit treatment is a great advantage, for the REIT’s income is taxed only once, while at least ninety per cent of such income is distributed. To an investor in a high tax bracket, who would prefer that the entity retain a large proportion of its income so that the stock would appreciate in value, such an arrangement is not particularly advantageous. However, since Congress was concerned with the small investor, see text accompanying notes 25-28 infra, this Comment will refer to the tax treatment afforded to REITs as a tax “advantage.”
24. INT. REV. CODE OF 1954, § 245(c)(5).
By granting tax advantages to REITs, Congress intended to encourage the growth of REITs in order to increase the funds available for equity financing of the large real estate developments and redevelopments needed in metropolitan areas. Moreover, in recognition of the shortage of private capital and mortgage money, Congress sought to encourage investment in real estate by a broad spectrum of the public and to stimulate the flow of money for homes, apartment houses, office buildings, factories, and hotels from sources other than the traditional government-guaranteed loans and loans from insurance companies, pension funds, and other financial institutions. Finally, it intended to afford the opportunity to small investors to participate in large scale, expertly managed real estate ventures, in which only a few wealthy individuals had previously been capable of investing. A similar opportunity had been afforded since 1936 to small investors in regulated investment companies, commonly known as mutual funds, with respect to income from stocks and bonds.

In addition to favorable tax treatment, the REIT offers many other advantages to the small investor who wishes to invest in real estate. It is said to be a hybrid between the two other forms of organization that have been used for investment in real estate—the corporation and the partnership—offering the best of each and the worst of neither. Like a corporation, the REIT offers centralized management and free transferability of shares as well as, in

26. Id. at 4.
27. Id. at 3-4.
This secures for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate equities and mortgages directly and, therefore, equates their treatment with that accorded investors in regulated investment companies.

In both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources. These advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangement; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which investors could not undertake singly.

Your committee believes it is also desirable to remove taxation to the extent possible as a factor in determining the relative size of investment in stocks and securities on one hand and real estate equities and mortgages on the other.

H.R. REP. No. 2020, supra note 25, at 3-4. It should be noted that some commentators feel that, although the reasons given by Congress for the passage of this tax advantage may have validity, the real reason for its passage was the effective lobbying of several business trusts from Massachusetts. Kahn, supra note 7, at 1016; Zarrow, Tax Aspects, in REAL ESTATE INVESTMENT TRUSTS II, at 41, 45 (Practising Law Institute 1970).

29. Oklahoma Fullers Earth Co. v. Evans, 179 Okla. 124, 125, 64 P.2d 899, 901 (1937).
most states, limited liability for shareholders. All this is offered, of course, without the double taxation that distributed corporate income must bear. In this respect, the REIT is like a partnership, for partnership income is taxed only to the partners and not to the partnership itself. However, a partnership has several characteristics not shared by the REIT. First, participation in a partnership is limited to those selected by the individual partners for their personal qualifications, and the death or notice of withdrawal of a partner signals the dissolution of the partnership; a REIT is open to investment by the public, and it continues to exist despite the death or withdrawal of a trustee or shareholder. Moreover, in most states the beneficiaries of a REIT are not personally liable for the debts of the business as are the general partners of a partnership. Finally, REITs have the potential to attract more investors than partnerships engaged in real estate investment, for several reasons. First, unlike partnerships, REITs can offer freely transferable shares. Furthermore, REITs generally sell their shares at cheaper prices than real estate partnerships offer. Finally, REITs are generally more diversified in their investments than partnerships.

It is apparent then, that, both in terms of organizational form and federal tax status, the REIT has much to offer certain investors. However, in order to draw any final conclusions on the relative attractiveness of this type of investment, it is necessary to ascertain the consequences currently imposed by state law on investment in this type of business.

II. Contract Liabilities

A. REIT Trustees

It is well settled that the officers, directors, and other employees of corporations are not personally liable on corporate contracts so

32. See text accompanying notes 58-67 & 73-76 infra.
33. Kelley, supra note 7, at 1004. Indeed, real estate investment and development corporations, which must pay corporate taxes, have been largely confined to investments offering high depreciation relative to cash yield in order to avoid double taxation. Id. at 1002.
34. INT. R.EV. CODE OF 1954, § 701.
35. J. CRANE & A. BROMBERG, PARTNERSHIP § 5(c) (1968).
36. Id. § 73.
37. H. HENN, supra note 31, at 91.
38. See text accompanying notes 58-67 infra.
40. Real estate syndicates, the most common form of real estate partnerships, usually sell shares ranging in price from 1,000 to 10,000 dollars each. Kelley, supra note 7, at 1004.
41. Partnerships typically only invest in one or two properties and thus expose the investor to many more risks. Comment, supra note 7, at 168.
42. Those who desire large dividend returns on their invested capital rather than capital gains income. See note 22 supra.
long as they are acting in their representative capacities. The law regarding liability of REIT trustees, however, is not so well settled. Although a few states have statutes stating that the trustee is not personally liable for such contracts, most of the law in this area is judge-made. Almost universally, courts have held that the trustee of a business trust is personally liable for contractual obligations incurred on behalf of the trust. This result is explained on the following ground:

A trustee is not an agent. An agent represents and acts for his principal, who may be either a natural or artificial person. A trustee may be defined generally as a person in whom some estate, interest, or power in or affecting property is vested for the benefit of another. When an agent contracts in the name of his principal, the principal contracts and is bound, but the agent is not. When a trustee contracts as such, unless he is bound, no one is bound, for he has no principal. The trust estate cannot promise; the contract is therefore the personal undertaking of the trustee.

However, most of the cases dealing with the liability of the trustees have involved attempts to limit that liability in the declaration of trust and in contracts between the trust and third parties. In such cases, the courts have generally stated that the mere addition of the word "trustee" or "as trustee" to the trustee's signature on a contract is insufficient to effect a limitation of liability. It has been held, however, that a trustee can be relieved of personal liability by a clause in the trust instrument, provided that the state's

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statutory law makes the clause effective. However, most courts have held that a third party who has not been given notice of such a clause is not bound thereby and can subject the trustee to personal liability. Even in some states that do not by statute make such trust instrument clauses effective, courts have concluded that liability can be successfully limited by the insertion of a provision in contracts with third parties that the trustees shall not be personally liable and that the creditors agree to look solely to the trust for the satisfaction of their obligations.

The liability of the trustees is a personal obligation, and execution on judgments secured by trust creditors may be levied upon personal assets of the trustee. In the absence of statute, only when such assets are not available is there a possibility that relief will be given in equity against the trust estate. However, if the trustees acted within their authority in undertaking the obligation and have paid it from their personal assets, states that have considered the matter have concluded that the trustees have a right to indemnity, first from the trust income, and if that is insufficient, then from the trust corpus. However, if the obligation was incurred without authority, or arose from negligent or willful conduct for which the


trustee is personally responsible, there is no right to reimbursement.\textsuperscript{53}

If the trust estate is insufficient to make the trustee whole when he has discharged a liability properly incurred in the administration of the trust, the issue arises whether he may obtain reimbursement from the beneficiaries.\textsuperscript{54} The only case that can be found on point, \textit{Darling v. Buddy},\textsuperscript{65} denied the trustee of a business trust the right to recover from the beneficiaries an amount he had paid toward a debt that he had contracted for the trust. The court analyzed the case in terms of certain general legal principles applicable to business trusts: that third parties may not hold persons liable as partners in an enterprise in the absence of a consensual partnership arrangement\textsuperscript{58} and that the trustee is a principal rather than the agent of the beneficiaries.\textsuperscript{57} Therefore, since third parties could not hold the beneficiaries personally liable for the debts the trustee had contracted, the court concluded that the trustee could not obtain indemnification from the beneficiaries for payment of such debts.

\textbf{B. REIT Shareholders}

Corporate shareholders generally have no liability for the corporation's contracts.\textsuperscript{58} A few states have statutes that insulate busi-

\begin{itemize}
\item \textsuperscript{53} Rubens v. Costello, 75 Ariz. 5, 251 P.2d 306 (1952); Sykes v. Parker, 250 Ill. App. 299 (1928); Winslow v. Young, 94 Mo. 145, 47 A. 149 (1900); Dunham v. Blood, 207 Mass. 512, 93 N.E. 804 (1911); McFadden v. Lecka, 48 Ohio St. 518, 28 N.E. 874 (1891). \textit{See generally Annot., supra note 30, at 142.}
\item \textsuperscript{54} Some commentators have stated that the trustee may or should be able to obtain reimbursement. H. \textsc{Hen}, \textit{supra} note 31, at 96; \textit{Scott, Liabilities Incurred in the Administration of Trusts}, 29 Harv. L. Rev. 725, 728 (1915); \textit{Symmonds, Business Trusts}, 15 Marq. L. Rev. 211, 215-16 (1931). However, their statements are based on an old English case, \textit{Hardoon v. Belilios}, [1901] A.C. 118, which really is not on point. The case held that a trustee who had been found personally liable on a debt of the trust could get reimbursement directly from the trust beneficiary since the trust assets were not enough to cover the payment. However, the trust involved there was not a \textit{business} trust, but a standard trust; moreover, there was only one beneficiary who owned the entire beneficial interest in the property held in trust. The court emphasized that the latter fact was extremely important in its decision, [1901] A.C. at 124, and implied that had there been several beneficiaries, as there are in the case of a REIT, it would not have decided the case the same way. Finally, the beneficiary in \textit{Hardoon} demanded from the trustee all the income from the trust property and paid all calls upon the price of the property, [1901] A.C. at 126-27. Thus, although legal title to the trust property was not in the beneficiary's name, he assumed all the benefits and burdens of ownership.
\item \textsuperscript{55} 318 Mo. 784, 1 S.W.2d 163 (1927).
\item \textsuperscript{56} 318 Mo. at 795, 1 S.W.2d at 167.
\item \textsuperscript{57} 318 Mo. at 799, 1 S.W.2d at 170.
\item \textsuperscript{58} H. \textsc{Hen}, \textit{supra} note 31, at 96. Under modern corporation laws, shareholders do have liability where they exercise the role of directors; in addition, in some states if they treat corporate assets as their own, undercapitalize the entity, or lead creditors to believe they will be personally responsible for corporate debts, they will be held liable for such debts. \textit{See id. at 250-59.}
\end{itemize}
ness trust shareholders from personal liability for the trust's contract debts; no state has a statute that provides otherwise.

However, there seems to be a division in the state case authority dealing with this problem. The majority view is that shareholders of a business trust will not incur personal liability for the trust's debts so long as there is a separation of management from beneficial ownership in the trust. However, the states that adhere to the majority view generally impose personal liability on the beneficiaries when they exercise sufficient control over trust affairs to make the trustees their agents. What constitutes "control" in any given case is a matter of fact. For example, where the only power given to the trust beneficiaries is the power to elect trustees annually, the beneficiaries are usually not held to control trust affairs. On the other hand, control has been found where the beneficiaries are given some combination of the powers to remove the trustees, to fill the vacancies, to amend the declaration of trust, and to prevent the sale of real estate.

A minority of courts have held that business trust shareholders are vulnerable to unlimited liability for trust debts regardless of


60. Betts v. Hackathorn, 159 Ark. 621, 252 S.W. 602 (1923); Goldwater v. Oltman, 210 Cal. 408, 292 P. 624 (1930); Levy v. Nellis, 284 Ill. App. 228, 1 N.E.2d 251 (1936); Greco v. Hubbard, 252 Mass. 171, 147 N.E. 272 (1925); Rosman v. Marsh, 287 Mich. 720, 288 N.W. 83 (1930); Darling v. Buddy, 318 Mo. 784, 1 S.W.2d 163 (1927). For additional cases from these and other states, see Annot., supra note 30, at 107 n.15.

61. Betts v. Hackathorn, 159 Ark. 621, 252 S.W. 602 (1923); Goldwater v. Oltman, 210 Cal. 408, 292 P. 624 (1930); Levy v. Nellis, 284 Ill. App. 228, 1 N.E.2d 251 (1936); Greco v. Hubbard, 252 Mass. 171, 147 N.E. 272 (1925); Rosman v. Marsh, 287 Mich. 720, 288 N.W. 83 (1930); Darling v. Buddy, 318 Mo. 784, 1 S.W.2d 163 (1927); Brown v. Bedell, 263 N.Y. 177, 188 N.E. 641 (1934). For additional cases from these and other states, see Annot., supra note 30, at 112 n.28.


control. In most of these states, this result follows from the fact that the business trust is not recognized as an entity.

Finally, in a fairly substantial number of states there simply is no statutory or case law concerning this problem. Whether beneficiaries of a business trust are liable for the debts of the trust in those states is apparently still a matter of conjecture.

III. TORT LIABILITIES

The trustees of a business trust, like corporate officers and directors, are personally liable for their own torts, including those committed.


One author suggests that at least two policy arguments can be mustered in favor of holding the shareholders personally liable: 1) business trust shareholders make their investments with profits in mind, so it is only fair that they should be responsible for the venture's debts; 2) such a policy solves the problem of deciding in each and every case whether the amount of control exercised is enough to warrant liability. Jones, supra note 7, at 23-24.

65. H. HENN, supra note 31, at 88. In Arizona, Kansas, and Louisiana, a trust is regarded as a corporation and failure to comply with corporation laws results in the imposition of individual liability upon the shareholders. In Kentucky and Indiana a business trust is held to be a partnership for purposes of imposing personal liability. In Texas a business trust is treated as a joint stock company, and shareholders bear personal liability. See authorities cited in note 64 supra.

The legal status of the business trust in Washington is currently unclear. Recent legislation has been passed which offers recognition to the business trust and which recognizes the trust's ability to immunize its shareholders from personal liability to third persons. Wash. Rev. Code Ann. §§ 23.90.010-900 (1961). However, since the business trust was previously regarded as invalid in Washington under an interpretation of the state constitution, State ex rel. Range v. Hinkle, 126 Wash. 581, 219 P. 41 (1925), the constitutionality of the enabling statute would appear to be open to serious question. 3 Z. CAVITCH, BUSINESS ORGANIZATIONS § 43.08(3) (1972).

Kentucky and Washington may be the only states where shareholders of a REIT may still be personally liable for the contracts of the REIT, for Arizona, Indiana, Kansas, and Texas all have statutes now that specifically exempt shareholders of a REIT, although not necessarily of any business trust, from personal liability. See authorities cited in note 59 supra.

66. Alaska; Colorado; Connecticut; Delaware; Georgia; Hawaii; Idaho; Iowa; Maine; Nebraska; Nevada; New Hampshire; New Mexico; North Carolina; Oregon; Pennsylvania; Vermont; West Virginia; Wisconsin; Wyoming.

67. However, Colorado, Iowa, Nebraska, New Mexico, North Dakota, Ohio, Wisconsin, and Wyoming are members of the Midwest Securities Commissioners Association, whose Statement of Policy Regarding Real Estate Investment Trusts attempts through the regulation of the sale of REIT shares to make limited liability of REIT shareholders the norm. See notes 123-26 infra and accompanying text.

68. H. HENN, supra note 31, at 456-57.
mitted in furtherance of the trust's business. In addition, they are personally liable for torts committed in the course of trust business by the agents and employees of the trust. It has been held that such employees are the servants or agents of the trustees and not of the beneficiaries so that liability cannot be shifted to the shareholders. However, one case has held that, at least where the deed of trust provides that the trustees shall not be liable for the torts of agents or employees of the trust, any judgment entered against the trustees on account of such torts shall be paid out of the trust estate.

The tort liabilities of the shareholders of a business trust follow much the same pattern as their contract liabilities. Like corporate shareholders, who normally incur no liability for the torts of corporate personnel, business trust shareholders generally are not personally liable for the torts of the trustees or trust employees even though committed in furthering the trust’s business. Those few states that have statutes in this area generally provide that business trust shareholders are to enjoy the same limited liability as shareholders of a corporation. However, once shareholders begin to exercise control over the trustees, every state that has considered the problem has held that they are personally liable for torts committed by the trustees in the furtherance of the trust’s business.

It should be pointed out that even if a state decides that the trustees or shareholders of a Real Estate Investment Trust should be liable for torts committed by REIT trustees or employees, as a

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73. H. Henn, supra note 31, at 408-05.

74. No cases have been found in which a business trust shareholder has been held liable for torts of the trust in the absence of control of the trustee by the shareholder.


practical matter such torts are likely to occur only rarely. The recent trend has been toward the formation of mortgage trusts,\textsuperscript{77} which limit their investments to mortgages and other income-producing liens against real property. The income of these trusts is derived primarily from interest earned and discounts received during the period of amortization of the mortgages.\textsuperscript{78} It is difficult to conceive of many situations in which an employee of an organization whose sole business is the buying and selling of mortgages might commit a tortious act resulting in injury to a member of the public.

It seems more likely that an employee of an equity REIT would have occasion to cause personal injury by engaging in tortious conduct since equity REITs invest primarily in the ownership of real property, such as shopping centers, industrial properties, and apartment buildings, which are frequently open to the public.\textsuperscript{79} Even for trustees and shareholders of an equity trust, however, there is little likelihood of being held liable to a member of the public given the requirements of the Internal Revenue Code that REIT investments be passive. To qualify for the tax advantages provided by the Real Estate Investment Trust Act an equity trust must hire an independent contractor to manage and operate its real property.\textsuperscript{80} If a member of the public is injured on the REIT's property, it is highly probable that the injury will have been caused not by an employee of the REIT but by an employee of the independent contractor.

\textsuperscript{77} Augustine, Introduction to Real Estate Investment Trusts, in REAL ESTATE INVESTMENT TRUSTS II, at 11-12 (Practising Law Institute 1970).

\textsuperscript{78} Kelley, supra note 7, at 1002. The mortgages may be long term or short term. Long-term mortgages are acquired as part of a “permanent” portfolio. Short-term mortgages for construction and other forms of interim financing, which generate a higher rate of return than the long-term mortgages, are included in the portfolio in order to increase the earning power of the mortgage trust. Id.

\textsuperscript{79} Id. These trusts have invested almost exclusively in commercial and industrial rental real estate, usually subject to mortgages or other incumbrances, and their primary source of income is from rents.

\textsuperscript{80} Section 856(d)(3) of the Code excludes from “rents from real property” any amount received with respect to real property if the trust “furnishes or renders services to the tenants of such property, or manages or operates such property, other than through an independent contractor from whom the trust itself does not derive or receive any income ....” Under this test, if upon audit it is deemed that the trust received one dollar for services to one or more tenants in a building generating $100,000 in annual rents, none of the income from that property will be deemed “rents from real property” and, if more than 10% of gross income, the trust will be disqualified. These restrictions are a part of the legislative scheme aimed at limiting the benefits of the real estate investment trust provisions to trusts which are passive investors in real estate. This particular subsection requires the trusts to engage an independent contractor . . . for the purpose of 1) furnishing or rendering services to the tenants and 2) managing or operating the real property. Kelley, supra note 7, at 1006. Trustees must manage the trust but may not manage or operate the trust property. REIT trustees can 1) establish rental terms; 2) choose tenants; 3) enter into and renew leases; 4) “deal with” taxes, interest, and insurance relating to tenants’ property; 5) make capital expenditures; and 6) make decisions about repairs and pay their cost. TREAS. REG. § 1.856-4(d) (1962).
Under traditional agency principles, one who hires an independent contractor is not liable for the actions of that contractor's employees. Thus, even if a state decides that REIT trustees or shareholders should be liable for the torts of REIT employees, the incidence of such liability in practice will be rare.

IV. EVALUATION OF CURRENT LAW AND POTENTIAL AVENUES TO REFORM

It is apparent that there are many states where the law on REITs is either uncertain or unfavorable and many others where there is no law at all on the questions of tort and contract liability of REIT trustees and shareholders. It was for these reasons that the House Ways and Means Committee concluded in 1965 that the use of REITs had not been so extensive as had been anticipated when the Real Estate Investment Trust Act was passed in 1960. As the Committee stated:

Real estate investment trusts have not been used as widely since 1960 as might have been anticipated from the type of tax treatment made available, primarily because of the requirement in the 1960 provision that the organization itself must be "an unincorporated trust or an unincorporated association."

In some of the States, the trust form of organization for real estate investments is not workable or, at best, the law is uncertain. . . . Even with [recent amendments in a few states to allow investment in passive real estate investment trusts], however, the application of the law in the case of real estate investment trusts generally remains uncertain, because the law of governing unincorporated trusts has been highly developed in only a relatively few States.

. . . [I]t has been found that many investors are reluctant to invest in trusts, because they do not understand their method of operation. Many believe that when they invest in trusts they are assuming liabilities and responsibilities to a greater extent than when they invest in a corporation. Thus, there appears to be a feeling that trust shares or certificates are not a suitable form of general investment.

A uniform, predictable legal approach to the liabilities of REIT trustees and shareholders would do much to stimulate the formation of and investment in REITs, which was Congress' purpose in enacting the Real Estate Investment Trust Act. Attempts to achieve the desired uniformity and predictability might take one of three forms: adherence by states to a uniform conflict of laws principle with respect to REITs, enactment by Congress of federal legislation, or adoption by states of new or revised substantive law on REITs.

81. See generally W. SEAVEY, AGENCY §§ 6, 11E, 82, 84 (1964).
82. H.R. REP. No. 481, supra note 9, at 3.
83. See text accompanying notes 25-27 supra.
These approaches will be surveyed and evaluated in the discussion that follows.

A. Conflict of Laws

It might seem, from the outset, that any fears trustees and shareholders have about possible contract and tort liabilities could be allayed by forming the trust in a state that would not hold them so liable. For example, a REIT could file its declaration of trust in Massachusetts, where trustees may be relieved of liability for business trust contracts and torts by clauses in the trust instrument or in contracts with third parties and where shareholders are not liable for REIT torts or contracts. The trustees and shareholders would then be protected by Massachusetts law if state courts adhered to a conflict-of-laws principle that the law of the state of formation governs disputes involving REIT trustees and shareholders. Such a conflict principle would be analogous to the traditional principle applicable to corporations: the local law of the state of incorporation is applied to determine the existence and extent of a shareholder's liability to the corporation for assessments or contributions and to its creditors for corporate debts, and to determine the existence and extent of a director's or officer's liability to the corporation, to its creditors, and to its shareholders. That analogous principles might be applicable to REITs is recognized by the Restatement of Conflict of Laws, which states that to the extent other forms of organization, specifically the business trust, enjoy the same attributes as business corporations, the choice of law rules set out in the chapter on business corporations should be applicable to them.

However, it cannot be assumed at present that every state court will apply the local law of the state of formation in determining whether to hold REIT trustees or shareholders liable for REIT torts and debts. First, there are no traditional conflict-of-laws rules applicable to business trusts. The Restatement says that, to date,

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86. Restatement (Second) of Conflict of Laws § 307 (1971).
87. Id. § 309.
88. Id., Introductory Note to ch. 13.

That most people who form REITs feel these conflict rules will be applied to REITs is strongly suggested by the great number of REITs, no matter where their headquarters are located, that are formed in Massachusetts. Out of 112 REITs listed in Moody's Investors Service, Inc., Bank and Finance Manual 1311-1992 (1972), 48 were formed in Massachusetts; another 25 were formed in California, Maryland, and Texas, all of which are friendly to REIT trustees and shareholders.
forms of organization other than the corporation and partnership "have engaged the attention of the courts only rarely in the field of choice of law." Moreover, the Restatement position is that the choice-of-law rules applicable to corporations should apply to business trusts, but only to the extent that the latter enjoy the same attributes as business corporations. The most important attribute of a business corporation, according to the Restatement, is limitation of the liability of the shareholder for any act or omission of the corporation. Since it has not been universally held that shareholders of a business trust are not liable for the acts or omissions of the trust and since, indeed, the case at bar might concern the very issue of whether to hold a shareholder liable for such acts, it cannot be stated with any certainty that every court will apply the corporate choice-of-law rules in litigation involving a Real Estate Investment Trust. Finally, the Restatement recognizes an exception to the traditional choice of law rules applicable to corporations: with respect to the particular issue whose resolution necessitates a choice of law, if some state other than the state of incorporation has a more significant relationship to the parties and the transaction, a court will apply the law of the other state.

If a court decides that corporate conflict rules do not apply to REITs, it will be faced with deciding which state's laws should be applied to determine the extent of REIT trustee and shareholder liability. In one analysis of REITs, the authors stated: "The essential question is whether a state court will select the law of the forum, the law of the REIT's property situs or the law of the state of REIT origin." To this list could be added the law of the state where the contract was signed or was to be performed, the law of the state where the tort occurred, the law of the state where the REIT carries on most of its business, and the law of the state where the REIT has its headquarters.

89. Restatement, supra note 86, Introductory Note to ch. 13.
90. Id.
91. Id.
92. See text accompanying notes 58-67 & 73-76 supra.
93. Restatement, supra note 86, §§ 6, 309.
95. It is beyond the scope of this Comment to examine all the factors that a state should consider in deciding in each case which of these laws should apply, or to discuss how various theories on conflict of laws promoted by various commentators would approach this specific problem. See Comment, Limited Liability of Shareholders in Real Estate Investment Trusts and the Conflict of Laws, 50 Calif. L. Rev. 696 (1962); Note, The Real Estate Investment Trust in Multistate Activity, 48
It should be noted that even if a court does not apply the law of the state of REIT formation and chooses the law of the forum or of some other state, there are few states whose law is particularly harsh on REIT trustees or shareholders. If a REIT simply avoided formation or investment in these few states, it could minimize the chance that their unfavorable law would ever be applied in a case in which the liability of the REIT’s shareholders or trustees is at issue.

Up to this point, however, attention has not been given to the situation in which a court decides that the law to be applied to determine trustee or shareholder liability in a particular case is that of a state that has no law at all on the subject. In such a situation, the court will have to guess what the other state would hold on the matter of trustee or shareholder liability. Logically, the court might conclude that the other state would adopt the majority opinion among states that have considered the problem. This conclusion would result in nonliability for both the shareholders and trustees if the trust instrument and third-party contracts contain clauses that provide for such nonliability. However, there is no certainty that a court would so decide.

The absence of firm conflict rules with respect to business trusts creates an atmosphere of uncertainty for REIT trustees and shareholders. Just as it is generally recognized that a uniform and predictable treatment of corporations is desirable and that a single body of law should govern a corporation’s operations to the extent possible, so does the resurgence of the business trust raise the need for a reasonably predictable legal environment. Probably the easiest way to achieve a uniform result in this area is for a state always to apply the law of the state where the trust was formed in determining trustee and shareholder liability. This solution would allow the trustee and shareholder to know their potential liabilities from the very inception of the undertaking. It would eliminate the need, which more complex choice-of-law rules would create, to decide on the facts of each and every case which state’s substantive law should apply.


96. See A. Bahr, ALIEN CORPORATIONs IN CONFLICT OF LAWS 89 (1953); 2 E. Rable, CONFLICT OF LAWS § (1947).
97. Comment, supra note 95, at 701.
98. For example, if a state decided that the conflict rule to be applied to business trusts were the rule of most significant contacts, it would then have to decide which
der the proposed solution, a REIT, which is in practically every respect like a corporation,99 would be treated as a corporation. Finally, this solution would reflect the result reached by most of the business trust cases involving conflict of laws.100

A possible qualification to this solution is that a court might employ the doctrine that the law of another state cannot be applied if it contravenes the public policy of the forum state.101 Under this doctrine, a forum might decide that it should not apply the law of the state of formation in litigation involving a REIT. However, such decisions should be rare. A statute of another state is not contrary to the forum state’s public policy merely because the forum has no statute on the subject,102 nor is a public policy conflict created by a mere variance between the law of another state and that of the forum.103

However, unless and until the conflict-of-laws rule suggested above is adopted by all of the states with which a REIT, its trustees, and its shareholders have connections, the risk remains that one of those states might apply the law of a state other than the state of formation and hold the trustee or shareholders liable for contracts or torts of the REIT. For a large REIT with holdings, trustees, and shareholders in many states this risk could be substantial. It seems apparent, then, that sufficient uniformity and certainty in the area of REIT trustee and shareholder liabilities cannot be achieved, at least in the immediate future, unless Congress alters the requirement that REITs be business trusts or states reform their business trust laws.

B. Possible Congressional Action

While potential investors in real estate could avoid any possibility of personal liability by operating in corporate form rather than as a REIT, corporations do not qualify for the special tax treatment given to REITs. The Internal Revenue Code specifically provides contacts of the particular REIT before it were “significant” and to which state they related. This might be difficult in the case of a large REIT holding property or mortgages in many states.

99. See text accompanying note 114 infra.


102. E.g., Warner v. Florida Bank & Trust Co., 160 F.2d 766 (5th Cir. 1947); Ciampittiello v. Campitelli, 134 Conn. 51, 54 A.2d 669 (1947).

that to qualify, a business must be either an unincorporated trust or an unincorporated association.104

The problem of potential REIT trustee and shareholder liability could be alleviated if Congress were to amend section 856 of the Internal Revenue Code to allow corporations to qualify as REITs. Congress could state that if a corporation met all the requirements as to sources of income and diversification of assets that are set down in sections 856-58 of the Code, it would not be taxed on any of its income that it distributed to shareholders as long as it distributed at least ninety per cent of its net income. Such a plan would come much closer to equalizing the treatment between shareholders in mutual funds and the shareholders in Real Estate Investment Trusts, an express goal of Congress in passing the Real Estate Investment Trust Act.105 Presently, mutual funds also must meet rigid asset and income requirements and distribute at least ninety per cent of their income in order to avoid federal taxation of amounts that they distribute to shareholders;106 unlike REITs, however, they are corporations and thus can guarantee limited liability to their shareholders, a guarantee that REITs cannot make at present. The proposed plan would not hinder the encouragement of investment in real estate, which Congress tried to foster in 1960;107 indeed, it might encourage even more real estate investment, for many small investors who have been afraid of the potential liabilities associated with the business trust form might be attracted to real estate investment corporations.108

An attempt was in fact made in 1965 to amend the Real Estate Investment Trust Act so that corporations could qualify as REITs and be eligible for the tax advantages granted such entities. The bill, H.R. 4260,109 would have provided that real estate investment corporations that met the conditions specified in the statute now applicable to real estate investment trusts would be eligible for “pass through” tax treatment if ninety per cent or more of their income were distributed to shareholders.110 Although the bill was endorsed

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104. INT. REv. CODE OF 1954, § 856(a).
107. See text accompanying notes 25-27 supra.
108. H.R. REP. No. 481, supra note 9, at 3. As the House Ways and Means Committee stated in 1965, after considering such a plan as has just been discussed:
[There is] no logical reason for granting regulated investment type treatment to real estate trusts and not to similarly situated real estate corporations. Moreover, making this treatment available to such real estate investment corporations would be particularly helpful to the small investor who has little understanding of the operations of trusts and who, therefore, would otherwise be unlikely to obtain a holding in any real estate parcel of relatively large magnitude.
Id.
110. The bill also would have amended the present requirement that the business
by the House Ways and Means Committee\textsuperscript{111} and passed unanimously by the House of Representatives,\textsuperscript{112} it apparently died in the Senate Finance Committee. No hearings were ever held in the Senate on the bill, it was never reported out of the Committee, and no legislative history can be found on the bill after it left the House floor.

No new movement to pass such an amendment has risen in Congress since that time. Thus, while the problem of REIT shareholder and trustee liability could easily be solved by Congress' allowing corporations to qualify as REITs, there is no indication that Congress is going to pass such an amendment, at least in the immediate future. The present problem of uncertain liabilities thus devolves upon the individual states for solution.

C. Possible State Action

In determining to what extent liability for REIT torts and debts should be imposed on the trustees and shareholders, states can find little guidance in the congressional history of the Real Estate Investment Trust Act. There is nothing in the \textit{Congressional Record}, in the Committee report accompanying the REIT Bill,\textsuperscript{113} or in any other source that indicates what, if anything, Congress intended in regard to such liabilities when it passed the original Act. Only one bit of legislative history suggests that Congress has even considered this problem: As noted above, when the House Ways and Means Committee endorsed the 1965 bill that would have allowed corporations to qualify for REIT status, it did so on the ground that the bill, by assuring small investors limited liability, would encourage them to invest in real estate ventures. However, the Senate's failure to act on the bill leaves unclear what inferences might be drawn from the bill's history about Congress' intentions.

1. Contractual Liability

In deciding whether to hold the trustee or shareholder liable for the contracts of a REIT, a state should probably look first to the law that is applied to the corporation, the entity most similar to the REIT. In fact, the business corporation and the REIT are virtually identical in their formal characteristics: 1) each has centralized management; 2) each is formed for the purpose of carrying on some kind

\textsuperscript{111} Id. at 3.
\textsuperscript{112} \textsuperscript{111} CONG. REC. 13964 (1965).
\textsuperscript{113} H.R. REP. No. 2020, \textit{supra} note 25.
of commercial activity for profit; 3) beneficial interests in the assets of each are evidenced by freely transferable certificates; and 4) the existence or life of each is not affected by the death, disability, or retirement of a shareholder, or by the sale or transfer of his interest.114 Since corporations and REITs are alike in so many respects, it would seem logical to hold that if corporate shareholders and officers are not personally liable for the contracts of their corporation, then their counterparts—the REIT shareholders and trustees—should not be held personally liable for the debts of the Real Estate Investment Trust.

However, there is one major difference between a REIT and a corporation: a corporation is a legal entity or artificial person distinct from the shareholders who own it,115 while a REIT is not. Indeed, it is because the corporation assumes obligations as a legal entity that shareholders have not been held personally liable for corporate contracts and other debts.116 Moreover, the corporation's status as a legal person allows the principles governing the liability of agents to third persons to be applied in the corporate setting, with the result that officers have not been held personally liable on corporate contracts executed by them.117 Thus, since a REIT is not an independent legal entity like a corporation, it is arguable that the corporate analogy does not really apply.

Although this distinction is cogent on its face, it is not persuasive when practical considerations are examined. So long as the REIT creditor is in no worse position than the corporate creditor, the fact that a REIT is not a legal entity is irrelevant. Since corporate officers and shareholders are normally immune from liability for the corporation's debts, a corporate creditor's recovery will generally be limited to the assets of the corporation.118 A state could put the REIT creditor in the same position as the corporate creditor by imposing personal liability on the trustee for REIT contracts while limiting the creditor's recovery to the value of the REIT assets, by permitting the trustee to reimburse himself from those assets, and by immuniz-

A famous business trust case carried the analogy even further: The corpus of the trust corresponds to the capital of the incorporated company; the trustees to the board of directors; the beneficiaries to the stockholders; the beneficial interests to shares of stock; and the declaration of trust to the charter. Schumann-Heink v. Folsom, 328 Ill. 321, 325-26, 159 N.E. 250, 252 (1927).
Historically, the application of trust principles to the conduct of commercial enterprise originated in Massachusetts as a result of the inability to secure corporate charters for acquiring and developing real estate without a special act of the legislature. Caplin, supra, at 1007.
116. Id.
117. 3 id. § 1117 (1931).
118. See text accompanying notes 43 & 58 supra.
ing REIT shareholders from liability except in situations where corporate shareholders would be liable. A similar way to accomplish the same end would be to hold that neither the trustee nor the shareholder shall be personally liable for REIT debts but that the REIT per se can be sued in the courts of the state. Suits directly against the trust have in fact been allowed in a few states. This solution, however, may prove too radical for states that cannot conceive of an unincorporated organization being sued in its own name.

From a practical standpoint, the scheme of holding the trustee liable to the extent of REIT assets for REIT contracts would allow the average shareholder, who has no real control of the daily operations of the REIT, to be free from liability. It would subject the persons most closely identified with the everyday operations of the trust—the trustees—to responsibility for the contracts they undertake without burdening them with debts that are not imposed on their corporate counterparts. Finally, under the proposed scheme the creditor of a REIT would be just as well off as a creditor of a corporation, for he could recover up to the full amount of the REIT's assets. A creditor who desired more security could ask the trustee to sign the contract and guarantee it in his own name, just as a corporate creditor who wants to be assured of a recovery that exceeds the extent of corporate assets can ask for a corporate officer's personal guaranty. Thus, the proposed scheme would treat like entities alike, assure uniformity and certainty, and abate the fears of potential investors, without affecting the availability of the federal tax advantage given to the Real Estate Investment Trust form.


120. To qualify for federal pass-through tax treatment, a REIT must distribute at least 90 per cent of its income. INT. R.EV. CODE OF 1954, § 857(a)(1). In contrast, a corporation generally retains a greater percentage of its income. In the aggregate, American corporations have distributed slightly over 50 per cent of their profits after taxes in recent years. 93 U.S. DEPT. OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES (W. Lerner ed. 1972). While this difference in distribution patterns might seem to create a disparity in the assets available to satisfy creditors of REITs and corporations, there are several factors that mitigate this apparent disparity. First, the REIT only distributes 90 per cent of its income that is left after all current liabilities have been met. Furthermore, equity REITs by definition invest in real property, which appreciates in value, see text accompanying note 79 supra, whereas corporations generally invest in assets that depreciate in value. Although mortgage REITs, see text accompanying notes 77-78 supra, do not invest directly in appreciable assets, the mortgages they hold are secured by real property. The only situation in which a mortgage REIT might be unable to pay its creditors would be that in which many of its mortgagors defaulted on their payments. In such a situation, the REIT or its creditors could foreclose on the underlying real property. Finally, most of the creditors of REITs are banks and other financial institutions. See generally Robertson, Sorting Out the Real Estate Investment Trusts, FORTUNE, Aug. 1970, at 173-75; Schulkin, Real Estate Investment Trusts: A New Financial Intermediary, NEW ENGLAND ECON. REV., Nov-Dec. 1970, at 2. It could be expected that such institutions generally will not lend money to a REIT unless they are assured that its assets will be sufficient to pay back the loan.
2. Tort Liability

A state must also consider whether a trustee should be personally liable for the torts of a fellow trustee or of personnel he has hired to carry on the trust's business, and whether a shareholder should be personally liable for such REIT torts. The solution that was suggested in the area of contract liability would seem equally appropriate here: that the trustee shall be personally liable for the torts of the REIT's employees but only to the extent of the REIT assets; that the trustee shall be permitted to reimburse himself from the trust assets; and that the shareholders shall not be liable except in the situations in which corporate shareholders would be liable. This would leave all the parties in the same relative position as their corporate counterparts.

The decision whether to hold REIT shareholders or trustees liable for REIT torts is not a serious problem for two reasons. First, as noted above, torts by REIT trustees or employees are likely to occur infrequently.121 Second, public liability insurance can be obtained at relatively little expense to cover potential trustee and shareholder liability.122

121. See notes 77-81 supra and accompanying text.
122. Telephone conversation of February 15, 1973, with Mr. Lawrence London, United Underwriters, Cleveland, Ohio.

Insurance may render obsolete some of the traditional common-law arguments that have been offered in favor of or against holding the trustees or shareholders liable for REIT torts. For example, it could be argued that imposing liability on a trustee for the torts of people he has hired to carry on the trust's business would tend to encourage a trustee to make sure that his fellow trustees and employees exercise caution in the execution of the trust's business. This is one of the justifications that have been given for respondeat superior in the law of agency. See W. Seavey, supra note 81, § 83. In addition, such liability might also cause the trustee to be much more selective in his hiring of employees. See id. Insurance, by insulating the trustee from personal loss, might weaken the effect of liability on the trustee's conduct. Two other reasons are generally given to justify respondeat superior: 1) the "deep pocket" theory, under which it is assumed that the master is more likely to be able to pay an injured person than the employee who injured the person, and 2) the "spread the loss" theory, under which it is assumed that the principal can more easily spread the cost of paying the injured person, through raising prices, than can the employee. See generally Calabresi, Some Thoughts on Risk Distribution and the Law of Torts, 70 Yale L.J. 499 (1961). In the absence of insurance, the "deep pocket" theory might not be particularly applicable to a REIT trustee, who may have limited personal assets. The "spread the loss" theory is likely to be unaffected by the availability of insurance.

With respect to the liability of a REIT shareholder for the torts of employees, it could be argued that shareholders invest in REITs to make a profit and that it is only fair that they be prepared to suffer some losses. Insurance would insulate shareholders from personal loss arising out of the REITs' operations. Another argument for shareholder liability is that it will provide another source of assets for people who are injured by employees of the undertaking. However, so long as the REIT trustee carries maximum insurance, there is no need for another source of assets. On the other hand, two reasons are generally given to justify the limited liability of corporate shareholders: 1) it encourages industry by allowing incorporated enterprises to avoid the expense of fully funding their enterprise, and 2) it makes it easier for corporations to offer their shares to the public. See Note, Should Shareholders Be Personally Liable for the Torts
Another approach to the problem of liabilities for REIT torts and contracts is offered by the Midwest Securities Commissioners Statement of Policy Regarding REITs.123 This Statement was issued by the Midwest Securities Commissioners Association, an association of the securities administrators of twenty-four states,124 and was intended to be a model for state regulation of the sale of REIT shares. It requires, among other things, that the declaration of trust provide that the shareholder shall not be personally liable for any of the obligations of the trust, that all written contracts to which the trust is a party provide that the shareholders and beneficial owners shall not be liable thereon, and that the trustees maintain adequate insurance against possible tort liability on the part of the trust.125 However, the Statement is not an effective solution to the problem, for it merely regulates the sale of securities in a state and does not alter the state's general tort or contract law. Moreover, because the Statement requires that substantial powers be given to shareholders, adoption of the Statement in states employing the control test might actually increase the incidence of shareholder liability.126

V. TAX LIABILITIES

A. Liabilities of Nonresident REIT Shareholders for Income Tax of State Where REIT Owns Property

One contemplating investment in a REIT, in addition to being cognizant of potential personal liability for the contracts and torts of REIT personnel, must also be aware that he might have to pay of Their Corporation?, 76 YALE L.J. 1190, 1195-98 (1967). These arguments, which would apply equally to REITs and REIT shareholders, may carry less weight if potential investors knew they could protect themselves from liabilities arising from a corporation's operations by procuring insurance.

124. Arizona; Arkansas; California; Colorado; Idaho; Illinois; Indiana; Iowa; Kansas; Kentucky; Michigan; Minnesota; Missouri; Nebraska; New Mexico; North Dakota; Ohio; Oklahoma; South Dakota; Texas; Utah; Washington; Wisconsin; Wyoming. I CCH BLUE SKY L. REP. ¶ 4751 (1969).
125. I CCH BLUE SKY L. REP. ¶¶ 4754 (1969). The Statement also attempts to control such matters as the manner of election of trustees and amendments of the declaration of trust. In addition, it imposes limitations upon expenses and prohibits certain types of investments and the issuance of securities of more than one class. Id.
126. The trustee or trustees may be removed by the vote or written consent of two thirds of the outstanding shares of beneficial interest, changes can be made in the declaration of trust or other instruments forming the trust with the vote or written consent of two thirds of the outstanding shares, and the trust may be terminated at any time by a vote or the written consent of two thirds of the outstanding shares. I CCH BLUE SKY L. REP. ¶ 4754 (1969). Under the control test applied to business trusts, if a shareholder had a combination of these powers, he was deemed to have control of the trust and was held liable for its debts. See cases cited in note 63 supra.

The Midwest Statement is not binding, either in whole or in part, on any of the individual member states of the Association unless it is expressly adopted or followed by the individual state. Indeed, very few of the member states have in fact adopted
income taxes to every state in which the REIT owns real estate.

The statutes of states that impose a personal income tax contain, in some form, provisions that a nonresident shall be liable for taxes on all income derived from real or personal property located in the state, on all rents, dividends, and other income derived from real property located in the state, and on all capital gains derived from real or personal property located in the state. However, the potential state tax liability of REIT shareholders is mitigated by several factors. First, several states have provisions in their statutes giving a nonresident a credit for any taxes paid to his domiciliary state on income earned from property in those states. For example, suppose shareholder S lived in state Y and his REIT invested in property in state X. X would give a credit to S on his X state income tax return for any tax paid to state Y on income derived from property in state X. Moreover, many of the states that have an income tax give their own residents credit for any taxes they have paid to another state on income derived from property located in that other state.

In addition, many state statutes declare that cash dividends shall be taxed only in the domiciliary state of a stockholder. Moreover, some statutes provide that dividends paid to nonresidents shall not be taxable in the state where the property that generated the dividends is located unless the property is used in a business, trade, or profession.

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129. E.g., MASS. ANN. LAWS ch. 62, § 6(a) (1971); MICH. COMP. LAWS ANN. § 206.255 (Supp. 1972); N.Y. TAX LAW § 620 (McKinney 1960); OHI0 REV. CODE ANN. § 5747.05 (Page Supp. 1971); PA. STAT. ANN. tit. 72, § 7314 (Supp. 1972).

sion by the nonresident in that state. Presumably these statutes would exempt a nonresident REIT shareholder from paying taxes to these states on the REIT dividends.

Finally, it is questionable whether a state could constitutionally tax a nonresident when his only connection with the state is his ownership of shares of a REIT which invests in that state. The United States Supreme Court has consistently held that a state may not tax a person unless it has jurisdiction over him. It has stated: "As to nonresidents, the jurisdiction [to tax] extends only to their property owned within the state and their business, trade or profession carried on therein; and the tax is only on such income as is derived from these sources." In light of this language, it is not clear that a state would have jurisdiction over a nonresident shareholder of a REIT that owns property in the state. REIT property is owned by the REIT trustee and not by the shareholder. Moreover, the REIT's business within the state is carried on by the REIT trustee and not by the nonresident shareholder. Finally, the income that the shareholder receives is not earned directly from the property in the state, but indirectly in the form of dividends.

International Harvester Co. v. Wisconsin Department of Taxation, however, lends support to the imposition of a tax on the dividends of a nonresident REIT shareholder, at least to the extent that such dividends are derived from property located in the taxing state. In that case the Supreme Court upheld a Wisconsin law that placed a tax on all dividends distributed by a foreign corporation to all of its stockholders, regardless of whether they were Wisconsin residents, in proportion to the income which the corporation earned within Wisconsin. Although this tax was collected from the corporation and not from its shareholders, the Court acknowledged that the incidence of the tax was in fact on the shareholders. Nevertheless, the Court stated: "A state may tax such part of the income of a nonresident as is fairly attributable either to property located in the state or to events and transactions which, occurring there, are subject to tax in Arizona. "Corporation" includes a business trust. Ariz. Rev. Stat. Ann. § 43-101(q) (1956).


134. § 3. CAVITCH, supra note 65, § 43.11.

135. 322 U.S. 455 (1944).

However, the fact that no other state has attempted to tax corporate dividends distributed to nonresidents\(^1\) seems to indicate that there is substantial doubt about the viability of the International Harvester decision. Even Wisconsin, after a long history of constitutional debate within the state, finally let its controversial statute lapse in 1951.\(^2\)

Another avenue to taxation of nonresident REIT shareholders would be opened if the Court were to hold that REIT shares are interests in land, rather than intangibles like corporate stock. In 1935, in Senior v. Braden,\(^3\) the Court did hold that business trust shares are interests in land. If this decision is still good law, a state with jurisdiction over a REIT's real estate could tax a nonresident shareholder on the portion of his REIT dividends attributable to that real property.\(^4\) However, Justice Stone, in a strong dissent in Senior, argued that business trust shares are no different from other intangibles and that the holder really has none of the incidents of legal ownership of the real estate that the shares represent.\(^5\) As one commentator has stated, it is impossible to guess how the Court would now resolve this issue.\(^6\)

### B. Liability of REIT for State Corporate Income Taxes

Among the states that have a corporate income tax the patterns of REIT taxation vary. Thirteen states directly incorporate the federal law and provide that those entities that qualify for REIT status under the Internal Revenue Code\(^7\) shall be taxed only on income that they have not distributed to shareholders.\(^8\) Six states partially

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\(^1\) 322 U.S. at 441-42.

\(^2\) It could be argued on the basis of International Harvester that a state may tax dividends distributed to nonresident REIT shareholders and earned by the REIT from property located in the state. As in International Harvester, the state might have to collect the tax directly from the business rather than from its shareholders. First, it is possible that although the Court upheld a tax on the distribution of dividends to nonresident shareholders, it might not uphold a tax placed on the receipt of such dividends. Second, the administrative burden of assessing such a tax directly upon nonresident shareholders and of attempting to collect the assessments would likely prove overwhelming.

\(^3\) At least no evidence has been found of any other state's attempting to do this.

\(^4\) See Teschner, The Death of a Tax, 1953 Wis. L. Rev. 76.

\(^5\) 295 U.S. 422 (1935).


\(^7\) 295 U.S. at 433-41.

\(^8\) § 3 G. BOGERT, supra note 45, § 308, at 629.


incorporate the federal law through a “piggyback” tax scheme. Under this scheme, a business trust must pay the regular corporate income tax, but only on federal taxable income, which for a REIT is its undistributed income.146 Nine states provide that only those entities that are taxed as corporations by the federal government are liable for the corporate income tax,147 thus probably excluding the REIT. Five states apparently subject the REIT to corporate income tax on all of its taxable income derived from the state.148

In the rest of the states, “corporations” are defined as corporations, joint stock companies, associations, and, in some states, insurance companies.149 Whether a REIT would be considered an association subject to this corporate tax is not clear. A few old cases held that business trusts were liable for the state corporate tax,150 but none was decided in a state whose current statute defines “corporation” in the manner described above. In the absence of a specific exemption, REITs would likely be considered associations subject to the state corporate income tax. This conclusion is supported by the fact that the wording of these statutes parallels the Internal Revenue Code,151 under which business trusts have been considered as associations subject to the federal corporation taxes.152

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147. DEL. CODE ANN. tit. 30, § 1901 (Supp. 1968); KAN. STAT. ANN. § 79-32.109 (Supp. 1971); ME. REV. STAT. ANN. tit. 36, § 5102(5) (Supp. 1972); MICH. COMP. LAWS ANN. § 206.81(1) (Supp. 1972); N.M. STAT. ANN. § 72-15A-2 (Supp. 1971); ORE. REV. STAT. § 316.012 (1971); VT. STAT. ANN. tit. 52, § 5811 (1970); W. VA. CODE ANN. § 11-24-3 (Supp. 1970) (however, an annual privilege tax may apply, W. VA. CODE ANN. §§ 11-13-1 to -25). A tenth state indirectly incorporates the federal law by stating that the income of a business trust shall be taxed as property held in trust—that is, taxed only on income which is not distributed to beneficiaries. ALA. CODE tit. 58, § 29(6) (Supp. 1971).
149. ALAB. STAT. § 43.20.340 (1971); ARK. STAT. ANN. § 84-2002(5) (1960); CONN. GEN. STAT. ANN. § 12-213 (1972); IOWA CODE ANN. § 422.32 (1971); MO. REV. STAT. § 145.441 (Supp. 1973); N.D. CENT. CODE § 57-38-01 (1972); PA. STAT. ANN. tit. 72, § 7401 (Supp. 1972); VA. CODE ANN. § 58-151.02(4) (Supp. 1972). In four of these states, however, even if a REIT is deemed a corporation, it will only pay state income tax on the income which it has not distributed to shareholders, for the tax is based on the entity's federal taxable income. ALAB. STAT. § 43.20.010 (1971); MO. REV. STAT. § 145.431 (Supp. 1973); N.D. CENT. CODE § 57-38-01.1 (1972); VA. CODE ANN. § 58-151.032 (Supp. 1972).
C. Liability of REIT for State Corporate Franchise Taxes

In addition to corporate income taxes, many states have corporate franchise or excise taxes based on the value of the corporation's capital stock; again, it is unclear whether REITs are subject to these taxes. Three states specifically state that business trusts are liable for these taxes,\(^{153}\) while two states indirectly impose these taxes on business trusts.\(^ {154}\) Most states, however, do not explicitly address this problem: several states do not define "corporations" in their corporation franchise tax statutes but nevertheless talk in terms of articles of incorporation or incorporated entities, thus seemingly excluding REITs from such taxation;\(^ {155}\) several others define "corporations" as all corporations, joint stock companies, associations, or other business organizations that have privileges, powers, rights, or immunities not possessed by individuals;\(^ {156}\) one state declares that an entity must pay the corporation franchise taxes if it pays corporate income tax to the state.\(^ {157}\)

VI. ALTERNATIVE METHODS OF TAXATION AND FACTORS RELEVANT TO A STATE'S CHOICE OF METHOD

In addition to the methods of REIT income taxation described above, at least two other possible methods might be employed. First, in that REITs perform many of the same functions as banks and other financial institutions—particularly lending money for investment in real estate with the loans secured by mortgages—the state could tax REITs in the same manner that it taxes such financial institutions. Second, since REITs are similar in certain respects to mutual funds,\(^ {158}\) a state, if it has a special tax scheme for mutual funds, could extend this scheme to cover REITs.

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\(^{154}\) WASH. REV. CODE ANN. §§ 23.90.040, 23A.40.060 (Supp. 1972) (business trusts are liable for all taxes which corporations must pay); W. VA. CODE ANN. §§ 11-12-7, 11-12-8, 47-9A-5 (1966) (business trusts are liable for all corporate license fees and taxes).


\(^{157}\) S.C. CODE ANN. § 65-606 (Supp. 1971). Theoretically, then, a REIT which distributes one hundred per cent of its income should not be liable for this corporate franchise tax since S.C. CODE ANN. § 65-223.1 (Supp. 1971) a REIT need not pay any income tax on income which it pays to its shareholders.

\(^{158}\) Both REITs and mutual funds provide a pooling arrangement, with beneficial
The number of factors that a state must consider in deciding which tax plan to adopt makes such a decision extremely complex. No one plan is best suited for all states, nor can a recommendation be made to any particular state without knowing all the facts that prevail in that state. The complexity of the problem can best be demonstrated by the following example. It might appear that if a state strongly desires an inflow of capital investment, it could accomplish this result by setting low rates of taxation on REIT income. Yet the solution is not so simple. In addition to the state's low income tax rates, the REIT trustees will compare the real property taxes, real estate transfer taxes, payroll taxes, and mortgage transfer taxes of the state to those of other states to determine where investment would be most advantageous. The trustees will also compare the expected rate of return on invested capital in the state with that in other states. If the REIT is of the equity variety, consideration will be given to the availability of qualified independent contractors in the area who can manage the trust's properties. Therefore, a low tax rate on REIT income will not necessarily ensure a large flow of capital investment into the state.

It might also seem that if a state is in need of tax revenue, it should not tax REIT income at a relatively low rate. However, insofar as the tax rate does influence the inflow of capital, a high rate might in some circumstances deter REITs from investing in the state, resulting in a smaller base of aggregate REIT income subject to the state's taxation and thus a smaller amount of total tax revenue derived from REITs than if REITs were taxed at a relatively low rate. Furthermore, to the extent that REIT investment has a multiplier effect on a state's economic activity, a tax rate so high that it deters REIT investment may have a retarding effect on total income and thus on total tax revenue generated in the state. Therefore, the factors that must be considered by a state in devising a scheme for taxing REIT income are so numerous and complex that a generalized solution cannot be formulated.

Many of the same complex factors are involved in constructing a scheme for taxing REIT shareholders on income derived from property in the taxing state. For example, whether a low tax rate on REIT shareholders would stimulate the inflow of capital investment will generally depend on the factors surveyed above. Thus, again, a generalized solution is not possible.

interests represented by transferable certificates, for small investors who could not otherwise obtain the diversification of assets or expert management for their capital that these entities offer. See H.R. REP. No. 2020, supra note 25, at 3-4.

159. See note 80 supra and accompanying text.

160. The tax rate on REIT shareholders will likely have the same effect on a REIT trustee's investment decisions as the tax rate on REIT income since the goal of the REIT is to maximize its shareholders' income.
VII. CONCLUSION

It is apparent that in the twelve years since the passage of the Real Estate Investment Trust Act, little or nothing has been done on the state level to clarify what tax, tort, and contract liabilities the REIT, its trustees, and its shareholders might face. The law on business trusts still varies widely among the states. While in some states the law on the liabilities of business trust trustees and shareholders is favorable, in others there is no law on the subject or the law is uncertain. Still other states would treat REIT trustees and shareholders unfavorably by subjecting them to liabilities that would not be imposed on the officers and shareholders of a corporation. These variations in state law on business trusts may create uncertainty for potential investors and thus hinder investment in REITs.

Therefore, it has been argued that in order to provide uniformity in the law and to treat like entities alike, a state's law on REITs should parallel its corporations law. To equalize treatment of corporate and REIT creditors, trustees should be liable for REIT debts and torts, but only to the limit of the value of the REIT's assets. With respect to state taxation of REITs and their shareholders, no definite conclusion can be reached; each state, on the basis of numerous complex factors, must choose the plan that best fits its own needs and desires.

Regardless of what plan is actually adopted, however, it is obvious that all states must clarify their laws on REITs. Until then a potential investor or trustee cannot be certain of the liabilities he may be undertaking.