Washington Law Review

Volume 37 | Number 4

12-1-1962

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REAL ESTATE INVESTMENT TRUSTS IN WASHINGTON

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In 1960 Congress adopted §§ 856-858 of the *Internal Revenue Code*[1] with the avowed purpose of granting to the small investor in real estate the same federal income tax advantages that are afforded investors in regulated investment companies.[2] However the tax advantages that are granted have not given rise to a general adoption of organizations which qualify for the tax advantages.[3] The major reasons for this lack of interest are the complexity of the sections themselves, problems raised by the regulations (many of which have been rectified by the final regulations which were adopted April 28, 1962), and problems raised by state law.

This article will discuss the Real Estate Investment Trust[4] with emphasis on Washington law, and will not discuss the problems of qualification under §§ 856-858 of the *Internal Revenue Code* since this subject has been covered by several articles.[5]

The *Internal Revenue Code* provides basically that an unincorporated trust or association with 100 or more shareholders, which otherwise would be taxable as a corporation, may elect to be exempt from federal corporate income tax to the extent that income is distributed to shareholders, provided that the following qualifications are met:

1. Ninety percent or more of taxable income is so distributed.
2. At least ninety percent of gross income is from dividends, interest, rents from real property, gain from the sale of stock or securities and real property, and refunds of real estate taxes.
3. At least seventy-five percent of gross income is from rents from

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[1] INT. REV. CODE OF 1954, §§ 856-58.

[2] HOUSE WAYS AND MEANS COMM. 86TH CONG., 2D SESS., REPORT ON H.R. 12559 (Comm. print 1960).

[3] At the time of the adoption of the final regulations, 52 trusts had filed registration statements with the SEC. Of these, 27 had been cleared. 4 P.H. FED. TAX SERV. ¶ 32,266.

[4] The Real Estate Investment Trust is referred to herein as REIT.

[5] Roberts, *The Real Estate Investment Trust—New Tax Savings Opportunities for Investors*, 1961 So. CALIF. TAX INST. 27 (1961). Walder, *Real Estate Investment Trusts*, 39 TAXES 664 (1961); 7 CCH 1962 STAND. FED. TAX REP. ¶ 8725.

real property, mortgage interest, or gain from sale of real property. Rents from real property do not include rent which the REIT earns from active participation in the management of properties or rents received from certain related tenants.

4. Less than thirty percent of gross income is from sales of stock or securities held for less than six months and real property held for less than four years.

5. At the end of each quarter at least seventy-five percent of the value of total assets is represented by "real estate assets," cash, cash items and government securities.

If these and other qualifications are met, then the trust escapes tax on income which it distributes to its shareholders, and the shareholders are taxed at ordinary or capital gains rates, depending upon the character of the income in the hands of the trust. No dividend received credit is allowed to shareholders. It should be noticed that in addition to satisfying the qualification sections of the *Code*, in order to get the tax advantages provided, the trust must make an election to be so taxed and must comply with information requirements of the regulations.[6]

ORGANIZATION OF REIT

In its usual form the REIT will be organized by having the title to property taken by one or more trustees. The trustee may wish to contract with an advisory organization experienced in real estate investments. The advisory organization will search for and suggest purchases to the trustee. Since the trust itself cannot actively engage in the management of real property without risking disqualification,[7] the trust must lease all of its property to management organizations or operate through an independent contractor. If the promoters of the trust are interested in receiving some return for their organizational efforts, this return may be realized either through an interest in the advisory or management organizations, or through ownership of shares of the trust. However, common ownership between the management company and the trust is limited by the Internal Revenue Service regulations.[8]

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[6] INT. REV. CODE OF 1954, § 857(a) (2); Treas. Reg. § 1.857-6; 1.857-7 (1962).
[7] INT. REV. CODE OF 1954, § 856(d) (3); Treas. Reg. § 1.856-4. (1962).
[8] INT. REV. CODE OF 1954, § 856(d); Treas. Reg. § 1.856-4 (1962).

TYPES OF REAL ESTATE INVESTMENT TRUSTS

The three basic types of REIT are "blank check trusts," "swap trusts" and "mortgage trusts."

Blank Check Trust

The "blank check trust" is one which sells its stock to the public without owning any property. The proceeds received from the public offering are used to purchase properties selected by the trustee. At the time of the public offering the trustee may indicate in the prospectus the properties he intends to purchase. However, unless the property is under option, the intentions expressed by the trustee and the disclosure of the terms he intends to offer may make it difficult to acquire the property on the most favorable terms.

Since a blank check trust will have no past earnings record or properties with which to interest the investing public, it may be difficult to sell shares of this type of trust unless the public has a good deal of faith in the trustee and advisers.

Swap Trust

The trustee of the "swap trust" attempts to exchange shares of the trust for property. There are several reasons why such an exchange could be advantageous to a property owner. The pooling of many properties by different property owners provides diversification of risk and the opportunity for the property owner to relieve himself of the obligations of management by transferring management to a centralized management firm.

Another possible advantage of the swap trust is liquidity. Whether this advantage will result depends on whether the trust's shares are freely transferable in a public market. If a market for the stock does exist, a property owner can achieve liquidity by exchanging his property for stock and leasing the property back if he desires to continue its operation. The property owner has exchanged an asset which may be difficult to liquidate for one that can be turned into cash in a few days with considerably less selling expenses. It may be possible for the trust to refinance the mortgage obligations on all properties exchanged at less than cost by negotiating one large mortgage loan secured by all properties and in this way achieve a smaller interest rate and a larger return for the property owners.

A major problem of the swap trust is whether or not to attempt to

escape the provisions of § 351 of the *Internal Revenue Code*.[9] Section 351 requires a tax free exchange if shareholders exchange property for stock and immediately after the exchange own eighty percent or more of the stock of the trust. If the trust wants a tax free exchange it will attempt to show that the different property owners who are exchanging properties at different times are part of one group and are classified as persons who control eighty percent or more of the stock of the trust. In order to avoid any argument with the Internal Revenue Service, the trust may escrow the properties and when the desired number of property owners has been located, exchange all properties in one transaction. If a tax free exchange is not desired the trust will want to show that each exchange is an isolated transaction and the particular shareholder involved in any one exchange did not have eighty percent control of the trust after the exchange. Although this may work with later exchanges, at least the first exchange will have to be tax free if there are no other shareholders at that time, since after the first exchange the first shareholder will have one hundred percent control.

The choice between a tax free exchange and a taxable exchange is not an easy one. If the exchange is tax free no tax will have to be paid by the shareholder, and the trust will take the cost basis for tax purposes that the shareholder had and its depreciation will be determined by that cost basis.[10] Since the amount of taxable income is dependent upon depreciation, the transfer of properties of equal value but differing cost bases will cause inequities among shareholders. On the other hand, if the exchange is taxable the trust will get a stepped-up cost basis but the shareholders will be required to pay tax upon the difference between the market value of the shares taken and the cost basis of the property exchanged.[11] Since the shareholder may not receive any cash from the exchange with which to pay the tax, he may not wish to enter the transaction.

Mortgage Trust

A mortgage trust is one which primarily holds mortgages rather than real property. Although mortgage trusts have been formed their desirability has been limited by the regulations adopted by many states. In California, for instance, a mortgage trust cannot lend more than sixty-six and two-thirds percent of the market value of any property.[12]

[9] INT. REV. CODE OF 1954, § 351.
[10] INT. REV. CODE OF 1954, § 362(a).
[11] INT. REV. CODE OF 1954, § 1001.
[12] 10 CAL. ADM. CODE, § 552(b).

Mortgage trusts appear to be less advantageous than alternative forms or organizations, which grant mortgages, such as savings and loan associations.[13]

Open End Real Estate Investment Trusts

Open end trusts are those which stand ready to redeem their own shares, and any of the three types of trusts listed above can organize on an open end basis. Although this is a common practice among mutual funds, REITs have encountered much opposition. The Midwest[14] and the California[15] regulations prohibit them. The SEC has proposed a ruling which would prohibit registration of an open end REIT which had most of its assets invested in property other than cash or securities with a readily determinable market value.[16] There are two major objections to open end trusts. The first is the lack of liquidity necessary to redeem more than a small number of shares unless the trust is holding large cash reserves. A mutual fund which invests in securities can convert to cash quickly even though fully invested, while a REIT cannot liquidate real estate quickly. The second objection is that a REIT cannot readily determine daily property values with sufficient precision to calculate the value of shares to be redeemed.[17]

The REIT in Washington

The major problem under Washington law is whether the so-called Massachusetts Trust, which is the form of business organization most conducive to the operation of a real estate business qualifying for the federal tax advantages,[18] can legally do business in the State of Washington. Although in 1959 the Washington legislature adopted the *Massachusetts Trust Act*[19] the Department of Licenses of the State of Washington has taken the position that it will not allow securities of a

[13] See comparison between REIT and savings and loan associations in Note, *Real Estate Investment Trusts—Equalization of Investment Opportunity or Unjustified Tax Break to Favored Interests,* 1961 Wash. U.L.Q. 436.

[14] See Statement of Policy of the Midwest Securities Commissioners Association reproduced in 1 CCH Blue Sky L. Rep. ¶ 4753-55.

[15] 10 Cal. Adm. Code § 552(i).

[16] Wall Street Journal, Aug. 14, 1962, p. 2.

[17] For a discussion of SEC problems of the REIT see Wheat & Armstrong, *Regulation of Securities of Real Estate Investment Trusts,* 16 Bus. Law 919 (1960).

[18] The final regulations allow business organizations other than Massachusetts Trusts to qualify as REIT, and therefore allow associations, general partnerships and limited partnerships. Since limited liability is of great importance to the passive investor, it is presumed that only the limited partnership will be used in place of the Massachusetts Trust. However, since the adoption of the new Kintner Regulations, Treas. Reg. § 301.7701 (1960), there will be no tax advantage for a limited partnership to qualify as a REIT.

[19] RCW 23.90.

Massachusetts Trust to be offered to the public in Washington until the constitutionality of the *Massachusetts Trust Act* is established. Since a REIT must have one hundred or more shareholders, the blessing of the Department of Licenses is essential.[20]

The concern of the Department of Licenses arises from two Washington cases decided in the 1920's: *State ex rel. Range v. Hinkle*[21] and *State ex rel. Colvin v. Paine*.[22] In both of these cases foreign common law business trusts were attempting to do business in Washington without paying corporate fees. To reach the end result that common law business trusts should not be allowed to do business in the same manner as corporations without being subject to laws governing corporations, the court in both cases held that common law business trusts are prohibited from doing business in this state, and are "without legal standing" in Washington courts.[23]

Although the evil which the court was attempting to cure is no longer present, because the 1959 *Massachusetts Trust Act* specifically provides that Massachusetts Trusts must pay all corporate fees[24] and are subject to "*applicable* rights and duties existing under common law and statutes of this state in a manner similar to those applicable to domestic and foreign corporations,"[25] the language of the *Range* and *Colvin* cases remains to haunt the REIT.[26]

In order to determine the constitutionality of the Massachusetts Trust in light of these cases, an action was filed in King County Superior Court by the Pacific American Realty Trust against the Department of Licenses to compel the Department to issue a permit allowing the Trust to offer its securities in the State of Washington.[27] On cross motions for summary judgment, the Superior Court of King County

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[20] RCW 21.20.320.
[21] 126 Wash. 581, 219 Pac. 41 (1923).
[22] 137 Wash. 566, 243 Pac. 2 (1926).
[23] State *ex rel.* Range v. Hinkle, *supra* note 21.
[24] RCW 23.90.040(3).
[25] RCW 23.90.040(4). (Emphasis added.)
[26] Another problem raised by the 1959 Massachusetts Trust Act is whether *applicable* corporation laws to which a trust is subject disqualify the trust for the federal tax benefit. The proposed regulations (Proposed Treas. Reg. § 1.856-1(d) (1)), provided that the trustee must be free from control of shareholders other than the right to elect trustees. The Washington corporation statutes contain provisions granting powers to shareholders, thus raising a question of whether a Washington trust could qualify for the federal tax benefits (see discussion 16 Bus. Law 900, 902 (1960). Although the final regulations require that the trustee must have "continuing exclusive control" over the management of the trust and trust property and the disposition of trust property (Treas. Reg. § 1.856-1(d) (1)), the requirement that he be free of shareholder control has been deleted (see discussion in Post and King, *Final REIT Regrlations Adopted,* J. TAXATION, July, 1962, p. 54.
[27] King County Superior Court Cause No. 586968 (July 13, 1962).

held that a Massachusetts Trust form of business organization is not illegal in Washington where it complies with laws relating to corporations. As will be discussed later in this article, the Superior Court decision is questionable if it implies that a Massachusetts Trust must comply with *all* statutory corporation laws in order to be constitutional. This case is presently on appeal to the Supreme Court of Washington.

It must be kept in mind that the Pacific American Realty Trust is a trust formed under the laws of Massachusetts which is attempting to sell securities in Washington and therefore no issue is before the court as to whether such a trust can be created under the laws of Washington. The Trust is merely attempting to sell its securities in this state.

The argument of the *Range* and *Colvin* cases is that the Massachusetts Trust violates Article 12 § 5 of the Washington constitution, which reads as follows:

> The term corporations, *as used in this article,* shall be construed to include all associations and joint stock companies having any powers or privileges of corporations not possessed by individuals or partnerships, and all corporations shall have the right to sue and shall be subject to be sued, in all courts, in like cases as natural persons. (Emphasis added.)

The court said in the *Range* case:

> It would seem that the framers of our constitution . . . wisely provided that the term 'corporations' should include 'all associations and join [sic] stock companies having any powers or privileges of corporations not possessed by individuals or partnerships' and thereby prevented the formation of self-organized associations of every kind for the purpose of transacting business without meeting the obligations and complying with the statutory regulations of corporations.[28]

The Department of Licenses takes the position in the *Pacific American Realty Trust* case that a Massachusetts Trust is a corporation within the definition of Article 12 § 5 because it has powers and privileges of corporations not possessed by individuals and partnerships, and therefore it must comply with all laws pertaining to corporations and must be formed under laws pertaining to corporations. The Department of Licenses argues that the import of the language quoted above in the *Range* case and the constitution is that only corporations, partnerships and individual proprietorships can conduct business in Washington, and that a form of business organization which is not a proprietorship or partnership must comply with the general laws relating to

[28] 126 Wash. 581, 587, 219 Pac. 41, 43 (1923).

corporations. The Department further argues that the 1959 *Massachusetts Trust Act* does not require that Massachusetts Trusts comply with *all* general corporation laws, and therefore such trusts are invalid.

The Pacific American Realty Trust argues in its memorandum filed in Superior Court that the *Range* and *Colvin* cases hold that Massachusetts Trusts are corporations within the meaning of Article 12 § 5 and therefore are a valid form of business organization only if they comply with laws relating to corporations. It is argued further that the 1959 *Massachusetts Trust Act* requires a Massachusetts Trust to comply with the laws applying to corporations, and therefore the objections of the *Range* and *Colvin* cases have been satisfied.

Although it is understandable that Pacific American Realty Trust would want to support its argument with an analysis which does not require the court to overrule prior decisions, there is still a good deal of language in those cases which supports the argument of the Department of Licenses, if those cases are correctly decided. In addition, the 1959 *Massachusetts Trust Act* itself is not clear as to whether a Massachusetts Trust must comply with *all* laws pertaining to corporations. The *Act*, after listing specific laws applying to corporations with which the trust must comply, states that the trust is subject to other "... *applicable* rights and duties existing under common law and statutes of this state in a manner similar to ... corporations."[29] (Emphasis added.) There appears, therefore, to be some question as to whether the statute requires trusts to comply with *all* corporate laws.

However, even though the Department of Licenses finds some support in the *Range* and *Colvin* cases it appears that these cases do not properly interpret the constitution and it is difficult to find support in the constitution for the propositions that only corporations (as defined in *statutory* law), partnerships and individuals can organize to do business in Washington, and that organizations other than partnerships and individuals must comply with *all* general laws applying to "corporations."

Many other states have a constitutional provision identical or similar to that of Article 12 § 5 of the Washington Constitution[30] and although

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[29] RCW 23.90.040.

[30] ALA. CONST. art. 13, § 13; ARIZ. CONST. art. 14, § 1; CAL. CONST. art. 12, § 4; IDAHO CONST. art. 11, § 16; KAN. CONST. art. 12, § 6; KY. CONST. § 208; MICH. CONST. art. 11, § 15; MINN. CONST. art. 1, § 10; MISS. CONST. art. 7, § 199; MO. CONST. art. 11, § 1; MONT. CONST. art. 15, § 13; N.Y. CONST. art. 10, § 4; N.C. CONST. art. 8, § 3; N.D. CONST. art. 7, § 144; PA. CONST. art. 16, § 13; S.C. CONST. art. 9, § 2; S.D. CONST. art. 17, § 19; VA. CONST. art. 12, § 1.

some states follow the rule adopted by the Washington court[31] other states have not come to the same conclusion.[32]

The two basic errors in the reasoning in the *Range* case are: (1) the court infers that individuals by contract can give themselves the powers and privileges of corporations, and (2) the court's conclusion that the definition of the word "corporations" contained in Article 12 § 5 was meant to be a general definition of the word "corporations" for *all* purposes.

The court in the *Range* case supports its conclusion that the Massachusetts Trust is a corporation by reciting several provisions of the trust instrument which purport to give the beneficiaries of the trust powers and privileges of corporations. For example, the trust instrument provided that the beneficiaries and trustees had limited liability. The court reasoned that since individuals and partnerships do not have limited liability (and other powers and privileges listed), the Massachusetts Trust had powers and privileges of corporations not possessed by individuals and partnerships. The fallacy of this reasoning is apparent because individuals and partnerships cannot give themselves limited liability as to the public in general by contracting among themselves; only the sovereign state can do this.[33] The trust can limit its liability to an extent by contracting with third persons, but so can individuals and partnerships. Courts in other jurisdictions have recognized that individuals cannot confer upon themselves the powers and privileges of corporations.[34]

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[31] Reilly v. Clyne, 27 Ariz. 432, 234 Pac. 35 (1925); Old River Farms Co. v. Haegelin, 207 Colo. 290, 276 P.2d 1047 (1929); State v. United Royalty Co., 188 Kan. 443, 363 P.2d 397 (1961); Fitch v. United Royalty Co., 143 Kan. 486, 55 P.2d 409 (1936); Weber Engine Co. v. Alter, 120 Kan. 557, 245 Pac. 143 (1926); Home Lumber Co. v. State Charter Board, 107 Kan. 153, 190 Pac. 601 (1920). In the *Reilly* case the statutory definition of corporation was the same as the constitutional definition which is not the case in Washington, and therefore the case does not necessarily support the position of the Washington court. There is no question that the state legislature can require a Massachusetts Trust to comply with the statutory corporation laws. The question is whether a constitutional provision similar to Article 12 § 5 of the Washington Constitution requires a Massachusetts Trust to conform to statutory law. See also American Ry. Express v. Asher, 218 Ky. 172, 291 S.W. 21 (1927).

[32] Brocki v. American Express Co., 279 F.2d 785 (6th Cir. 1960); State v. Cosgrove, 36 Idaho 278, 210 Pac. 393 (1922); Spotswood v. Morris, 12 Idaho 360, 85 Pac. 1094 (1906); Michigan Trust v. Herpolsheimer, 256 Mich. 589, 240 N.W. 6 (1932); Attorney General v. McVichie, 138 Mich. 387, 101 N.W. 552 (1904); Forest City Mfg. Co. v. ILGW, Local No. 104, 233 Mo. 935, 111 S.W.2d 934 (1938); Hodgkiss v. Northland Petroleum Consol., 104 Mont. 328, 67 P.2d 811 (1937); Gifford v. Fargo, 176 N.Y. Supp. 568 (Sup. Ct. 1919); Strawberry Hill Land Corp. v Starbuck, 124 Va. 71, 97 S.E. 362 (1918).

[33] "A common law trust is not a corporation. It is based upon voluntary action of individuals." Michigan Trust v. Herpolsheimer, 256 Mich. 589, 240 N.W. 6, 9 (1932).

[34] In Spotswood v. Morris, 12 Idaho 360, 85 Pac. 1094, 1099 (1906), the court said in holding that a constitutional provision identical to that of Washington did not prohibit

Since only the sovereign can grant powers and privileges of corporations, Article 12 § 5 of the Washington Constitution can apply only to joint stock companies and associations which have been granted such powers by the State,[35] and at the time of the *Range* and *Colvin* cases Washington had not granted any powers and privileges of corporations to Massachusetts Trusts.

If a joint stock company or association is not granted powers or privileges of a corporation under local law, does the fact that it is granted such powers by a foreign sovereign cause it to come within the constitution provision? The only case found which discussed this point directly was *Forest City Mfg. Co. v. ILGW, Local No. 104.*[36] In this case a labor union as an unincorporated association was contending that it was a corporation under a constitutional provision identical to Washington's Article 12 § 5. The union argued that federal law gave it the powers and privileges of a corporation not possessed by individuals and partnerships in provisions pertaining to income taxes and anti-trust. Although recognizing the power of the federal government to create corporations, the court cited the following rule:

> ... we have no doubt at all that powers or privileges alleged to have been conferred upon associations and organizations such as appellant by two federal statutes in question should in any event be disregarded as not sufficing to effect appellant's legal status under the constitution and laws of this state. This in brief for the reason that the creation of a corporation or suable entity is an exercise of sovereign legislative power peculiar to the sovereignty which purports to exercise it, and having no

Massachusetts Trusts: "To possess or exercise powers or privileges of corporations requires a sovereign grant, a franchise which said association has not and does not profess to possess." The court concluded that the Massachusetts Trust could not give itself the powers and privileges of a corporation, and therefore it was not affected by the constitutional provision.

Even the supreme court of Kansas, from which comes a majority of the cases supporting the Washington decisions (see note 30), admitted in Fitch v. United Royalty Co., 143 Kan. 486, 55 P.2d 409, 412 (1936): "But just what powers a common law trust does enjoy in Kansas which are not possessed by individuals and partnerships the court has not had occasion to decide."

See also cases cited in note 31.

[35] Such was the situation in the case of Keystone Bank v. Donnely, 19 Fed. 832 (E.D. Pa. 1912). Pennsylvania, by statute, allowed the creation of so-called "partnership" organizations which were allowed to carry on a banking business. The statute gave the "partnership" several powers and privileges of corporations, including limited liability. The court held that under a constitutional provision identical to Washington that the "partnership" was an association having some powers and privileges of corporations not possessed by individuals or partnerships, and therefore came within the constitutional provision. Although the court then came to the questionable conclusion (as did the Washington court in the *Range* case, *supra*) that the "partnership" was a corporation within the meaning of Pennsylvania *statutes* as well as its constitution, the case indicates the type of organization which validly comes within the constitutional provision.

[36] 233 Mo. 935, 111 S.W.2d 934 (1938).

> extraterritorial effect except by permission of those other sovereignties within whose limits the corporation so created may desire to carry on its operations.[37]

Therefore, even if a foreign sovereign gave a Massachusetts Trust powers and privileges of corporations, they would not be recognized in Washington unless this state specifically recognized such powers by statute. It is interesting to note that the statute giving foreign "corporations" powers and privileges in Washington[38] applies only to companies *"incorporated"* in other jurisdictions, and Washington law was the same at the time the *Range* and *Colvin* cases were decided.[39] It is suggested that this would not give a Massachusetts Trust any powers or privileges of corporations in Washington.

In summary then, there was nothing in Washington law to give a Massachusetts Trust powers and privileges of corporations, and the *Range* and *Colvin* cases are therefore questionable. However, since the time of these Washington decisions on the Massachusetts Trust, the 1959 *Massachusetts Trust Act* has given the Massachusetts Trust some of the powers and privileges of corporations (such as limited liability), and assuming that a Massachusetts Trust comes within the definition of a joint stock company or an association, the provisions of Article 12 § 5 of the Washington Constitution would apply now to the Massachusetts Trust. This requires a fresh look at Massachusetts Trusts by the Washington court.

The second criticism of the *Range* and *Colvin* cases is that they conclude that the definition of the word "corporations" contained in Article 12 § 5 of the Washington Constitution was meant to be a general definition of the word for all purposes. The definition of "corporations" in Article 12 § 5 is limited to that section by its own terms. Article 12 § 5 is merely a definition of the word "corporations" as that term is used in Article 12, and it states that the term as there used includes all associations and joint stock companies "having any powers or privileges of corporations not possessed by indivduals or partnerships." In other words, the word "corporations" applies in Article 12 to incorporated companies and unincorporated organizations which have any powers or privileges of incorporated companies. It is difficult to see how a form of organization can "violate" a definition as is stated in the *Range* case. A form of organization is either within or without the

[37] *Id.* at 938.
[38] RCW 23.52.
[39] Wash. Sess. Laws 1890, ch. 9, §§ 1-3 at 288.

term of a definition. It is also difficult to see how this definition "prevents" the formation of unincorporated businesses which have any powers or privileges of incorporated companies as is stated in the *Range* case.

It is suggested that a proper interpretation of § 5 of Article 12 is that certain unincorporated associations must comply with the provisions of Article 12 which specially mention "corporations," but the section does not preclude the formation of those unincorporporated organizations. For example, such an unincorporated business must be formed under general laws and not special acts (Article 12 § 1), and it shall not issue stock except to bona fide subscribers, or issue bonds except for money or property received or labor done (Article 12 § 6), etc. There is much authority for this interpretation in other jurisdictions.[40]

It is also difficult to interpret Article 12 § 1 of the Washington Constitution to mean that all businesses which are not individuals or partnerships must comply with general *corporation* laws as is argued by the Department of Licenses. Article 12 § 1 says that "corporations" (*i.e.*, incorporated companies and unincorporated companies having any powers or privileges of corporations) must be formed under general laws and not special acts. This section does not say that all unincorporated companies having any powers or privileges of corporations must organize under general corporation law, but merely that any law allowing the formation of incorporated companies and such unincorporated companies must apply generally to all and cannot be created by special act.

The Washington Code has a different definition of a "corporation"

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[40] In Hodgkiss v. Northland Petroleum Consol., 104 Mont. 328, 67 P.2d 811, 816 (1937), the court said in construing a Montana constitutional provision identical to Article 12 § 5 and criticizing the conclusion of the Washington court: "All of these decisions overlook the fact that the constitutional provision by its own terms declares that the word "corporation" shall have a certain meaning as applied to the article of the Constitution in which it is found. Many courts from other jurisdictions having an identical constitutional provision have noted this distinction and said that the provisions of the constitution apply no further than the Article to which it refers."

In Brocki v. American Express Co., 279 F.2d 785, 786 (6th Cir. 1960), in construing the word "corporation" in the New York constitution, the court said: "This means no more than that for the purposes stated in those sections 1, 2, 3 and 4 of Article X, joint stock companies are subject to the same regulations as corporations."

The court said in Attorney General v. McVichie, 138 Mich. 387, 101 N.W. 552, 553 (1904), in holding that the definition of "corporations" did not extend beyond the constitution: "Had the constitution makers so intended, they could easily have said so, and the fact that the provision was limited to the term as used in the preceding section indicates a contrary intention."

Other cases have also held that the constitutional definition of the word "corporations" was not meant to be a general definition. See cases cited at note 31.

than the Washington Constitution. In the Code a "corporation" is defined as an organization which is created under Chapter 23 RCW,[41] whereas a business trust comes within the definition of an "unincorporated association."[42] At the time this definition was adopted the legislature must have felt that the definition in Article 12 § 5 of the Constitution was not intended to carry over to the statutes.

In referring to the Washington decision in the *Range* case that the constitutional definition of the word "corporations" is a general one, the Montana Supreme Court said in *Hodgkiss v. Northland Petroleum Consol.*:[43]

> To say that because of this constitutional provision the trust here involved becomes a corporation in one breath, and in the next to say that it is not a corporation since it failed to comply with certain statutory provisions is not logical to say the least.

A reading of Article 12 of the Washington Constitution in light of today's situation without the benefit of past Washington judicial interpretation which applied to a different situation, would indicate that unincorporated companies having any powers or privileges of corporations can be formed in Washington as long as they comply with Article 12.

Thus it is suggested that the *Massachusetts Trust Act* of 1959 is not in violation of the Washington Constitution, even if Massachusetts Trusts are not required to comply with *all* general corporation statutory laws.

It must now be seen if the Supreme Court of the State of Washington will hold that the Massachusetts Trust is an invalid form of business organization or whether the Court will hold Massachusetts Trusts to be valid either by overruling prior Washington decisions, or by construing them to allow Massachusetts Trusts, if such trusts comply with *all* corporate statutory law. It is suggested that the proper decision would be to overrule the prior decisions and to leave the determination of the meaning "applicable" corporate laws either to the legislature or to later decisions when specific problems arise.

State Regulation

The next major problem the REIT will have to face in Washington if the *Massachusetts Trust Act* of 1959 is held to be constitutional is the

[41] RCW 23.01.010(1).
[42] RCW 23.01.010(14).
[43] 104 Mont. 328, 67 P.2d 811 (1937).

adoption of appropriate regulations by the Department of Licenses or regulatory laws by the legislature governing the activities of the REIT in Washington. There is little argument that some regulation is necessary. If the REIT is a desirable form of business organization, appropriate regulation should assist its growth by promoting investor confidence. The question is whether these regulations should take the form of full disclosure regulations such as those of the SEC and those adopted by the State of New York,[44] or regulations such as were adopted by the Midwest Securities Commissioners Association[45] and the California Department of Investments, Division of Corporations[46] which regulate the manner in which the trust is administered. A trustee who must steer the path laid down by the complex *Internal Revenue Code* and Internal Revenue Service regulations, and regulations such as those adopted in California, has no simple task.

The problem in adopting regulations is to adequately protect the public without discouraging the formation of trusts, assuming that the REIT is deemed a desirable form of business organization for Washington. If the *Massachusetts Trust Act* of 1959 is held constitutional, hearings will probably be held soon thereafter to consider proposed regulations. The type of regulations which were adopted in California will undoubtedly be considered since it is understood that the proposals have been made to have the midwestern and western states adopt uniform regulations.[47] Those interested in REIT in Washington should familiarize themselves with those regulations in order to determine whether their adoption would be desirable in Washington.

The California regulations place a straitjacket on the REIT, and make it of questionable value as a form of business organization. The most controversial provisions restrict the methods by which the promoters of the trust can profit by its formation and restrict the type of investments which the REIT can make.

In most cases the persons who promote the trusts will be those who hope to operate the properties, or give investment advice to the trust, or those who hope to make a commission from finding and transferring assets to the trust. The investing public will be injured to the extent that these persons are allowed to take unreasonable compensation for their services from the trust. On the other hand, if these persons are

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[44] N.Y. GEN. BUS. LAW §§ 352 c-j (McKinney Supp. 1962).
[45] 1 CCH BLUE SKY L. REP. ¶¶ 4753-55.
[46] 10 CAL. ADM. CODE §§ 549-52.
[47] Los Angeles Mirror, July 11, 1961.

restricted from taking reasonable compensation for their services, the REIT will not be used and passive investors will not have an opportunity to avail themselves of the advantages of this form of investment.

An example of the type of restrictions found in the California regulations is § 549.1(f)[48] which provides that contracts with independent contractors "ordinarily" will have to be awarded by competitive bidding to the lowest qualified bidder. Since in the usual situation those who can perform services for the REIT will be the only ones interested in going to the trouble of organizing them, this restriction would eliminate most of the incentive of the promoters. Even if the fees charged by the promoter are reasonable, another contractor could underbid the promoter and take advantage of the promoter's work. Realizing this inequity the regulations were amended by the addition of a provision which allows the Commissioner to waive competitive bidding if he is shown that a contractor is qualified and is charging reasonable rates. The Commissioner's use of the discretion granted by the section will determine how restrictive it will be in its operation.

Section 549.6(h)[49] of the California regulations carries the restrictions even further by providing that no assets of the trust may be acquired directly or indirectly from or conveyed to any trustee, employee, advisor of the trust or independent contractor with the trust, nor may any such person receive any remuneration for such acts. An exception to this rule provides that assets may be so transferred by such persons only upon formation of the trust or shortly thereafter. This provision would reduce any interest a real estate salesman might have in promoting a trust, since any position of influence which he might have with the trust would eliminate his ability to receive even a reasonable commission for his services. The regulations attempt to ameliorate this provision by allowing the Commissioner to waive the regulation as to particular transactions, but the regulation provides that such waivers should be rare.

Where fees and expenses may be paid, they are restricted. Section 549.7[50] provides that investment advisory contracts cannot provide for a total annual compensation of more than 1% of the net assets of the trust. Net assets are valued at cost less depreciation, or at market value, whichever is less. This means that if a trust has $100,000.00 worth of assets at cost, the advisory fee cannot exceed $1,000.00.

[48] 10 CAL. ADM. CODE § 549.1(f).
[49] 10 CAL. ADM. CODE § 549.6(h).
[50] 10 CAL. ADM. CODE § 549.7.

Depreciation will reduce the amount of this fee over the years. It may be difficult to find an investment advisor at these rates.[51] The expenses of the trustee, including salaries of all employees, printing, and other miscellaneous expenses, are limited to $5,000.00 or 1% or net assets, whichever is greater. Excluded from the expenses covered by this limitation are: depreciation, insurance, interest, taxes, maintenance and upkeep of trust assets, payments to independent contractors, compensation to investment advisors, reasonable sales commissions, and reasonable appraisal fees.[52] But even with these exclusions the expense allowance does not appear reasonable.

The restrictions on types of investments which the real estate investment trust can make are also extensive. The trust may not invest more than 10% of its assets in non-income producing real property, such as vacant land, or property on which the principal permanent buildings have not been completed.[53] This last restriction may reduce an important area of possible profit-making for the trust, since there appears to be nothing under federal law which would prevent a trust from constructing new buildings.[54] However, under the California regulations not more than 10% of the trust's assets could be used for such construction, since during the construction period the assets being constructed would be non-income producing property, and an investment in the type of property on which the improvements were being constructed is severly restricted.

The restrictions on mortgage financing are also extensive. A REIT cannot invest in property which has an encumbrance with an unpaid balance exceeding two-thirds of the property's fair market value.[55] In addition the regulation provides that the aggregate unpaid balance of all encumbrances to persons "other than banks, insurance companies or other institutional lenders" cannot exceed 10% of the fair market value of the property. This provision would appear to eliminate purchase money mortgages and purchases on real estate contract, and require refinancing through institutional lenders of every property purchased. The Statement of Policy of the Midwest Securities Com-

[51] The Statement of Policy of the Midwest Securities Commissioners, *supra* note 45, allows investment advisors to receive annual compensation equal to one-half of 1% of the net assets.

[52] 10 CAL. ADM. CODE § 549.8.

[53] 10 CAL. ADM. CODE § 552(a). The Statement of Policy of the Midwest Securities Commissioners, *supra* note 45, allows only 5% of the trust assets to be invested in non-income producing property.

[54] N.Y.U. 20TH INST. ON FED. TAX, 671 at 673 (1962).

[55] 10 CAL. ADM. CODE § 552(d).

missioners[56] has a provision similar to the California regulation, except that purchase money mortgages are expressly allowed. The exception for purchase money mortgages has been eliminated from the California version of the regulations.

The regulations also prohibit investment in real estate contracts[57] and mortgages except first mortgages on improved land where the mortgage encumbrance does not exceed two-thirds of the value of the property securing it.[58] The trust cannot borrow, by way of unsecured loans, more than 2% of the net value of total assets.[59]

Also prohibited by the California regulations are the issuance of more than one class of stock,[60] issuance of shares guaranteeing any fixed return, [61] redeemable shares, [62] (thus eliminating open end trusts), and warrants or options.[63]

Any property acquired (other than government securities and corporate securities listed on a *national exchange*[64] and property used in the operation of the trust) must be appraised by an independent contractor satisfactory to the Commissioner, and property cannot be purchased for more than such appraised value.

A REIT must have a net capital of not less than $100,000.00[65] and non-corporate trustees must post a surety bond in an amount not less than $100,000.00 or ten percent of the par or stated value of all shares of stock, whichever is greater. [66] The bond need not exceed $500,000.00. Some have felt that this is a higher bond than is needed to adequately protect the public.

The California regulations are more restrictive than the policy state-

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[56] Statement of Policy of Midwest Securities Commissioners, *supra* note 45, at § 14(e).

[57] 10 CAL. ADM. CODE § 552(c).

[58] 10 CAL. ADM. CODE § 552(b). Investment in mortgages other than the mortgages allowed by this regulation may be made to the extent that such mortgages, plus any investment in non-income producing property held by the trust does not exceed 10% of the trust's assets. The Statement of Policy of the Midwest Securities Commissioners allows the trust to invest in mortgages to the same extent as permitted by savings and loan associations under local law.

[59] 10 CAL. ADM. CODE § 552(e). The Statement of Policy of the Midwest Securities Commissioners allows unsecured loans up to 8% of the value of the net assets of the trust.

[60] 10 CAL. ADM. CODE § 522(g).

[61] 10 CAL. ADM. CODE § 522(h).

[62] 10 CAL. ADM. CODE § 522(i).

[63] 10 CAL. ADM. CODE § 522(o).

[64] This exception does not appear to include stocks listed on local exchanges, and stocks traded over the counter. Such stock would have to be appraised and this would seem to be a needless expense.

[65] 10 CAL. ADM. CODE § 549.5.

[66] 10 CAL. ADM. CODE § 549.3.

ment issued by the Midwest Securities Commissioners Association, of which California is a member. The Midwest Statement of Policy has no provision for competitive bidding for contracts with independent contractors, no bonding requirements, allows a greater amount of unsecured debt by the trust, allows a more lenient policy on investing in mortgages and mortgage financing, and does not require appraisals on purchases of assets other than real property.[67]

It is the opinion of this writer that the adoption of regulations similar to those adopted in California, taken together with the complexity of the *Internal Revenue Code* and the Internal Revenue Service regulations, would substantially discourage the formation of real estate investment trusts in the State of Washington, especially since the investment climate in Washington has not been as favorable as that of California. It is submitted that the investor can be adequately protected without regulations which reduce the already narrow path of allowed activity for the REIT to a tight-rope.

One form of regulation which would protect the investing public without discouraging the formation of trusts would be that which required complete disclosure to the investor of all policies of the trust which concerns matters covered by regulations such as those adopted by California. Instead of the state administrative agency determining what is good or bad for an individual investor, such regulations would allow the investor to make this determination for himself by choosing whether or not he wished to invest in such a trust, and would cause sufficient information to be furnished him so that an intelligent decision could be made. For example, instead of regulations which prohibit the trust from investing in vacant land, the regulations would require that the trust set out its policy on investment in vacant land. If the trust should decide that in its particular circumstances a policy permitting twenty-five percent of its assets to be invested in vacant land would be appropriate, the investor would be notified of such a policy and could then determine whether or not he wished to invest in such a trust. In order to protect the investor from future changes the regulations could provide that all matters upon which a policy declaration is deemed desirable be embodied in the declaration of trust, and that the declaration of trust could not be amended without at least a two-

[67] Even where an appraisal is required by the Statement of Policy of the Midwest Securities Association, *supra* note 45, it may be eliminated if the purchase price comes within a formula provided for in § 13 of the Statement.

thirds vote of the beneficiaries.[68] The regulations would require that the issuance of shares of the trust to investors be accompanied by a prospectus and that the prospectus must state the trust's policies on certain specified matters. This approach does not protect the investor against himself, but does give the investor, either by himself or through his investment advisor, the opportunity of knowing what he is purchasing, and it gives the REIT maximum flexibility in formulating its own policies.

SUMMARY

In the face of a complex federal code and Internal Revenue Service regulations and possible restrictive regulations, and a not completely clear state statute governing Massachusetts Trusts, only the brave will venture into the form of business organization known as the Real Estate Investment Trust. Against these complexities and unknowns, these adventurers must weigh the value of the tax advantages provided and the investor appeal it might generate.

If the Washington Supreme Court decides that the *Massachusetts Trust Act* of 1959 is constitutional all problems will not be solved. If the basis of the decision is that prior decisions were correct but held the Massachusetts Trusts constitutional only if it follows *all* corporate statutory law, the adventurer will have to decide how to apply a large number of corporate laws that appear to be inapplicable to Massachusetts Trusts. If the court adopts the better rationale and overrules prior decisions, the adventurer will still have to decide what is meant by "applicable" corporate laws in the 1959 *Act*. A supreme court decision which would resolve this dilemma would be most helpful.

If the *Massachusetts Trust Act* of 1959 is held constitutional, the adventurer must be prepared to assist the Department of Licenses in formulating regulations which will allow the REIT to operate effectively in Washington.

[68] The Statement of Policy of the Midwest Securities Association, *supra* note 45, now contains a provision that the declaration of trust can only be changed by two-thirds vote of the holders of the outstanding shares of beneficial interest.