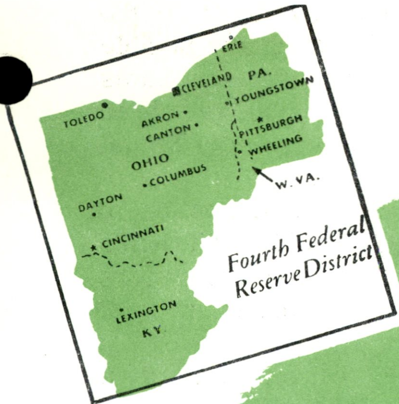
FOR PRESS RELEASE AFTER 7:45 P. M. FRIDAY, DECEMBER 27, 1963



Business Trends

Prepared in the Research Department of the
FEDERAL RESERVE BANK OF CLEVELAND
Serving the Fourth Federal Reserve District

REAL ESTATE INVESTMENT TRUSTS

Recently, a leading executive in the field of real estate investing stated that he had permanently withdrawn from the business of forming new real estate syndicates. He also predicted that real estate investment trusts would replace syndicates in the field of real estate investment. In view of this development it may be well to review the purposes and functions of real estate investment trusts and to see how they differ from syndicates.

A real estate investment trust is defined as an unincorporated association. Essentially, there is little difference between a real estate investment trust and a securities investment trust or mutual fund, other than the medium of investment that each employs.

In contrast, a real estate syndicate is a group of individuals who pool their funds to buy real estate, in exchange for proportionate partnership interests. The threat of being classified as an association taxable as a corporation has, however, restricted most syndications to a single real estate investment. As a consequence, each new acquisition involves a new syndicate, with the problems of organization and capitalization. Furthermore, complications have arisen when some syndicators recently found they were unable to pay investors the high returns that they had originally promised. A few syndicators have also disclosed personal financial troubles, with several being indicted on charges of fraud. These considerations lead to an interest in the investment trust type of organization.

Background. The origin of real estate investment trusts, or REIT's, can be traced back to Massachusetts in the early part of the nineteenth century. Since Massachusetts law imposed restrictions on the ownership of real estate by corporations, the trust became a popular substitute. The trust arrangement permitted investors to pool their funds to purchase real estate, with the added advantages of diversification of investments, limited personal liability and better management. The trustees issued shares of beneficial ownership that were readily transferable. These benefits still pertain to REIT's. The trust was widely used for real estate development in this country until 1913. The Revenue Act of that year provided that corporate tax laws would apply to "associations". The 1913 Act did not contain a strict definition of "association", and subsequent Supreme Court rulings discouraged the use of the trust form.

In 1936, securities investment trusts were granted special tax relief by the Revenue Act of that year. The relief permitted them to pass their income through to stockholders

Broadcast by William L. Frazier, Assistant Economist, Federal Reserve Bank of Cleveland, over WGAR Cleveland, Friday, December 27, at 7:45 p. m.

without first paying the corporate tax assessment. For unknown reasons, real estate trusts did not press for equal consideration at that time, and the trust was nearly forgotten as a legal form for investing in real estate.

Recent Revival. After World War II, as real estate investment regained popularity, a relatively small group of individuals and institutions began to campaign for tax treatment for REIT's that was similar to the special privileges of mutual funds. Their efforts were rewarded by a 1960 amendment to the Internal Revenue Code, which provided basically the same treatment for REIT's that was previously provided for regulated investment companies.

According to the amended income tax regulations, REIT's may qualify for special tax treatment only if certain clearly defined requirements are met. A review of some of the important provisions of the bill will be helpful in understanding the nature of REIT's. In order to first qualify as a trust, an REIT should: be managed by one or more trustees; have transferable shares or certificates evidencing beneficial ownership; not hold any property primarily for sale to customers in the ordinary course of its business; and be owned by 100 or more persons.

In addition to these status requirements, certain asset and income requirements are imposed. Most important is a requirement that 75 percent of the value of assets must be represented by real estate investments, cash, or Government securities.

The principal restriction on the income of an REIT requires that 90 percent of gross income be derived from dividends, interest, rents from real property and gains from the sale or disposition of securities and real property. Additional requirements restrict further the sources of REIT income and limit speculative opportunities.

A trust that meets these and other detailed requirements of the 1960 amendment will qualify as a real estate investment trust. If the trust then distributes 90 percent of taxable income in dividends, the corporate tax rates do not apply to that portion of earnings paid to shareholders. Thus, while shareholders must pay income taxes on distributed net income of an REIT, the double taxation that applies to normal corporate profits is avoided. The REIT form offers this distinct advantage to owners of real estate that produces taxable net income.

Since enabling legislation was passed in 1960, REIT's have gained renewed favor in the real estate field. Some existing real estate organizations have adopted the form. In addition, new trusts have been organized with capital derived from registered offerings of shares of beneficial interest to the public.

The National Association of Real Estate Investment Funds estimates that the registration statements of 40 REIT's are currently effective under the rules of the Securities and Exchange Commission, providing for share offerings of about $300 million. Actual public offerings, with a value of approximately $250 million, have been completed. In addition to these 40 trusts, there are at least 20 REIT's that were in existence, or have been created since the adoption of the Act through conversion to the trust form.

Public offerings of REIT shares, which are usually moderately priced, make real estate investment economically feasible to investors who previously felt that such investments required large amounts of capital. REIT's will also permit real estate promoters to reach funds never before available to them. As a consequence, the REIT may prove to be as important a financial intermediary in the real estate industry as investment trusts have proven to be in the securities industry.

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