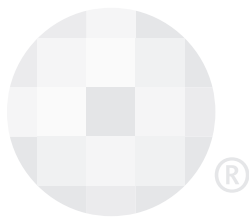


Modern REITs and the Corporate Tax: Thoughts on the Scope of the Corporate Tax and Rationalizing Our System of Taxing Collective Investment Vehicles

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David F. Levy, Nickolas P. Gianou and Kevin M. Jones analyze the history of both REITs and our corporate tax system, discuss how REITs came to fall within the corporate tax, and examine whether real estate investment companies should ever have been subject to the corporate tax in the first place.

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It is revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV. It is still more revolting if the grounds upon which it was laid down have vanished long since, and the rule simply persists from blind imitation of the past.

—Oliver Wendell Holmes¹

I. Introduction

This article is partially a commentary on recent events and partially an academic discourse on tax. On the commentary front, this article focuses on real estate investment trusts (REITs) and their inclusion in a high-profile, often times shrill, policy debate on the scope of the corporate tax. On the academic front, this article takes a hard but honest look at how our profession uses premises to frame policy debates; how a tax policy debate can become skewed, and ultimately unproductive, when we fail to check our premises before accepting them as the starting place for our policy analysis; and how a tax policy debate can turn 180 degrees if faulty premises are corrected.

This article advances two arguments. First, the current policy debate on the proper taxation of REITs has been based upon and driven by our collective view on the proper “default” tax classification of REITs as corporations. This default view has been based incorrectly on a line of authorities that was discredited intellectually, found unworkable and subsequently discarded by the government two decades ago. As a result, startling though it may be, our profession has been thinking about REITs in the wrong way for a long time and has relied on incorrect thinking to frame and conduct a tax policy debate that has been skewed against REITs.

Second, once we adjust the premises underlying the debate to properly reflect the policy objectives underlying the corporate tax, it becomes clear that REITs have never properly belonged in the corporate tax base. Indeed, despite the views of some REIT critics, the REIT regime actually advances the policy objectives underlying the corporate tax. All of this suggests that the REIT regime, rather than being curtailed, should be expanded to include asset classes other than real estate.

Those are bold statements, and we will back them up. But we first need to set the table with some background on the REIT industry and the dynamics affecting the current debate on the proper taxation of REITs.

A. Source of the Current REIT Debate

For the uninitiated, REITs are pretty simple creatures: they are vehicles through which small investors can pool their

resources in order to invest in real estate and mortgages on real estate. By pooling their resources in this way, small investors collectively can acquire a diversified portfolio of professionally managed real estate assets, which would otherwise be unfeasible for most individual investors.² REITs can thus be thought of as collective investment vehicles similar to mutual funds (commonly referred to as “RICs” in tax parlance), except that instead of focusing on stocks and securities, REITs focus on real estate. Because Congress has historically viewed diversified, professionally managed assets as being inherently less risky for smaller investors than individual direct investments, vehicles such as RICs and REITs have not been subject to the corporate tax. The theory here has been relatively simple: If collective investment were subject to the corporate tax while direct investment could be done without being subject to the corporate tax, the tax system would incentivize small investors to pursue a riskier savings (*i.e.*, direct investment) strategy to avoid having their savings diluted through the 35-percent corporate tax.

REITs can be classified using any number of criteria, including investing style, asset class and shareholder-level characteristics.³ Although many of the topics discussed in this article are applicable to all types of REITs, we focus primarily on publicly traded REITs that own real estate catered to business tenants because those REITs have been the epicenter of the policy debate addressed in this article.

The Internal Revenue Code (the “Code”)⁴ provides REITs with certain tax benefits and subjects REIT shareholders to certain tax drawbacks compared with regular C corporations and their shareholders. The primary tax benefit accorded to REITs is at the entity level: a deduction for dividends paid to shareholders, which results in the REIT not being subject to corporate tax on income that is distributed to its shareholders.⁵ The shareholder-level tax drawbacks include higher taxes for domestic individuals who receive dividends from a REIT⁶; the inability of corporate shareholders to claim the dividends received deduction for dividends received from a REIT⁷; the limited ability of non-U.S. shareholders to enjoy full treaty benefits with respect to dividends received from a REIT⁸; and, in certain cases, the imposition of the unrelated business income tax on certain pension funds that receive dividends from a REIT.⁹

In addition to encouraging diversification through collective investment, these benefits and drawbacks were viewed as placing small investors in public REITs on par, from a tax perspective, with wealthy individuals and institutional investors that own rental real estate through private partnerships.¹⁰ The REIT regime thus reflects the fact that, between the end of World War II and the enactment of the modern REIT legislation in 1960, the overwhelming

majority of new rental real estate ventures were conducted through private partnerships,¹¹ for a simple reason: rental real estate investments are designed to produce current yield for investors, and the imposition of a corporate level tax would shred that yield.¹² Thus, if private real estate rental businesses were required to operate in C corporation form, investors might find returns from rental real estate insufficient to justify investment and either shift capital to other investments or demand harsher economic terms for real estate investments.¹³ The result would be an increase in the cost of capital for real estate ventures or a decrease in the amount of capital devoted to real estate ventures (or a combination of the two). Given the importance of real estate to the national economy, Congress viewed these results as unacceptable.¹⁴ Thus, when Congress adopted the modern REIT regime in 1960, the regime was designed both to produce for small public investors tax results similar to those enjoyed by investors in private real estate partnerships and to increase the amount of capital available for real estate investment.¹⁵ Once the REIT regime was made to work as intended, REITs expanded significantly.¹⁶ Today, generally speaking, if rental real estate investment is going to take place, it must do so through an entity that is not subject to the corporate tax, but only public REITs generally offer investment opportunities for small investors.

Given REITs' simplicity, one would be forgiven for asking just how REITs became embroiled in a tax policy debate. The answer, we believe, is a toxic mix of several factors: capital markets developments that have encouraged many C corporations to spin off their real estate business units, dispose of their real estate or convert to REIT status; increased scrutiny from media and political circles unfamiliar with the quirks and nuances of REIT taxation; and a pair of faulty premises that helped frame the tax policy debate in a way that demonizes the REIT industry.

Turning to the first component of this "toxic mix"—changes in the capital markets—a number of developments have contributed to the growth of REITs in the past 15 years (and in the seven or so years since the financial crisis in particular). First, the requirement that REITs distribute at least 90 percent of their taxable income means that REIT stock is the type of yield-producing security that tends to become extremely popular, and extremely valuable by historic standards, when nominal interest rates in developed countries stay near (and, in some cases, below) zero for a long time, as they have since 2008.¹⁷ Second, due to changes in both technology and finance, REITs have been able to provide investors with access to new asset classes, such as cell towers, fiber-optic networks and electricity transmission and distribution systems. Third, ratings agencies generally

value capitalized leases more favorably than mortgages with similar payments, which has put pressure on publicly traded companies to lease real estate from third parties rather than own their real estate.¹⁸ Fourth, any non-real estate company that owns the real estate in which it conducts business is vertically integrated to that extent and is bucking a long-standing general trend away from vertical integration in favor of specialization.¹⁹

These developments, taken together, have contributed to the growth of the REIT industry and the variety of businesses operating in REIT form. For example, the increased trading multiples (and therefore the stock price) of REITs encouraged a relatively small number of real estate-focused C corporations to convert to REIT status (so-called C-to-REIT conversions) in order to take advantage of the increase in stock price and the corresponding reduction in the cost of their equity capital. Over time, the increased value of REIT securities helped spawn the expansion of REITs into "nontraditional assets," by increasing access to capital markets for ventures focused on those assets, such as cold storage warehouses, wireless communications towers, records storage facilities, outdoor advertising space, electricity transmission and distribution systems, natural gas pipeline systems, fiber-optic data-transmission networks and storage space for data servers, commonly referred to as "data centers." Favorable treatment of leased real estate by ratings agencies and general trends away from vertical integration have been more generally responsible for many of the recent transactions in which C corporations either engaged in C-to-REIT conversions or spun off their internal real estate business units in the form of newly created REITs ("REIT spin-offs").²⁰

Moving to the second component of our toxic mix—attention in media and political circles—the simple truth is that, whenever the capital markets' deal *du jour* is perceived as providing unique tax benefits, the inevitable scrutiny from the press is likely to spill over into tax policy debates at multiple levels. For reasons that probably have a lot to do with the complexity and nuances inherent in the REIT tax regime and misconceptions about the extent to which the use of REITs reduces overall tax revenues, the public debate around the recent growth of REITs has been fueled by a good deal of misinformation in both the media and political spheres. Among other things, this misinformation has created a perception among some commentators that REITs in general, and C-to-REIT conversions and REIT spin-offs in particular, are motivated by tax planning rather than business objectives and are designed more to raid the fisc than advance a bona fide business goal.²¹

This perception rests, we believe, on two false premises, which have skewed the tax policy debate regarding REITs:

first, the income of a REIT should be subject to the corporate tax in the first instance;²² second, the recent developments in the REIT space create a material and inappropriate drain on the fisc. The effect of these premises on the debate on the proper taxation of REITs is easily seen in the sort of questions typically debated: whether it is appropriate for the corporate tax base to be narrowed by carving out a special “exemption”²³ for REITs and whether C corporations should be able to “avoid tax”²⁴ by converting to REIT status or spinning off their real estate.²⁵ The framing of these questions makes sense only if one accepts the two premises stated above; and once the questions are framed this way, the “borderline hysteria”²⁶ of the media and political debate around REITs becomes understandable.

The second of these premises—that REITs create a material and inappropriate drain on the fisc—has been addressed impressively by Professor Borden.²⁷ As summarized in Part V.C below, Professor Borden concludes that, because of the various distribution requirements imposed on REITs and the higher taxes generally imposed on REIT shareholders as compared with C corporation shareholders, the negative fiscal impact of REIT spin-offs and C-to-REIT conversions is in all likelihood substantially lower than most people seem to believe and, in certain cases, may be immaterial. The authors agree wholeheartedly with that analysis.

The remainder of this article is therefore devoted to the first premise—that the income of a REIT should be subject to the corporate tax in the first instance.

B. Addressing the Premise That REITs Belong in the Corporate Tax

In addressing the premise that REITs belong in the corporate tax, this article asks three questions of its own. First, should REITs have been subject to the corporate tax in the first instance? Second, if not, do any of the modern developments in the REIT space undercut that conclusion? Third, if REITs should not be subject to tax in the first instance, what implications does that conclusion hold for other types of investment vehicles?

On the first question, we analyze the historical reasons for, and the policy objectives underlying, the corporate tax and conclude that, from a policy perspective, REITs should never have been subject to the corporate tax and, furthermore, that the REIT regime in fact advances rather than hinders the policy objectives underlying the corporate tax. On the second question, we analyze the modern developments in the REIT space and conclude that those developments do not undercut the conclusion that REITs do not belong within the scope of corporate tax in the first instance.

On the third question, after concluding that REITs do not belong, and have never belonged, within the scope of the corporate tax, we analyze the policy implications of that conclusion. One of these policy implications is that that current debate on the proper taxation of REITs is really a more general debate about the role of collective investment vehicles in our tax system. Accordingly, the thrust of our policy argument is that the main problem

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with the current system is that our two most popular collective investment vehicles—REITs and RICs—do not represent the entire universe of potential collective investment vehicles. This means that investments in certain asset classes that are suitable for collective investment are subject to the corporate tax while others are not. Because we see no tax policy justification for this disparity, our primary policy recommendation is that the REIT regime should be expanded to include a number of other assets that can be owned by one party and leased to another or owned by one party and financed by another. Thus, in our view, the problem with the REIT regime is not that it is too broad but that it is too narrow. To us, once the premises of the current policy debate are corrected, this outcome is a sensible result.

Part II of this article provides necessary background and context by discussing the requirements that an entity must satisfy in order to be a REIT. Part III discusses the historical policy objectives of the corporate tax. Part IV discusses the historical development of REITs in our tax system, while Part V debunks the proposition that REITs belong in the corporate tax system. Part VI contains our policy recommendations.

II. Summary of the Current REIT Tax Regime

In order to appreciate the policy discussion that follows, it is necessary to review, at least briefly, the current set of tax rules governing REITs. The full set of rules—contained

mostly in Code Sec. 856 through Code Sec. 859—are fairly complicated and technical. But the basics are reasonably digestible and provide necessary context for the remainder of this article.

A. The Consequences of Being a REIT: Benefits and Drawbacks

As one might suspect from all the media attention that REITs have received in recent years, there are a number of benefits to qualifying as a REIT. By far the most important of these benefits is the ability of a REIT to deduct the dividends that it pays to its shareholders.²⁸

This “dividends paid deduction,” which is not available to most other corporations,²⁹ allows a REIT to eliminate its corporate-level tax simply by distributing its net taxable income to its shareholders. The result is a single shareholder-level tax on the income earned by the REIT, as illustrated in Figure 1.

FIGURE 1.¹

	Regular C Corporation	REIT
Income	\$ 100.00	\$ 100.00
Corporate tax rate	35%	0%
Corporate tax (after dividends paid deduction)	\$ (35.00)	\$ –
Dividend	\$ 65.00	\$ 100.00
U.S. shareholder tax rate	23.8%	43.4%
Tax on U.S. shareholders	\$ (15.47)	\$ (43.40)
Shareholders’ after-tax distribution	\$ 49.50	\$ 56.60

ENDNOTE

¹ Figure 1 illustrates the tax effects of investment in C corporations and REITs by taxable U.S. shareholders only. In practice, foreign and tax-exempt investors may comprise a greater proportion of REIT shareholders than of C corporation shareholders.

The existence of the dividends paid deduction, though powerful in its ability to reduce or eliminate corporate-level tax, cannot by itself fully explain the popularity of REITs. After all, real estate is commonly owned in entities treated as partnerships for tax purposes—entities that do not even need a dividends paid deduction because they are not subject to entity-level tax in the first place. And although all publicly traded entities, as a general rule, are treated as taxpaying corporations *per se*,³⁰ there is an exception for publicly traded partnerships that do what REITs do.³¹

Why, then, would anybody choose a REIT over a non-taxpaying partnership? The answer is largely explained by

the ability of a REIT (but not a partnership) to distribute its income in the form of corporate dividends. This enables a REIT (but not a partnership) to report investor income on Form 1099 and, among other things, limits the extent to which (i) individual shareholders have to file complex federal and state tax returns, (ii) tax-exempt investors have to report unrelated business taxable income,³² and (iii) non-U.S. investors have to report “effectively connected income.”³³

This is not to say that REIT status is without its drawbacks. In some respects, shareholders may get a better result from owning a regular C corporation. For example, dividends from most regular C corporations are treated as “qualified dividend income” that is currently taxed in the hands of individuals at reduced maximum rates (the same 20-percent maximum rate that applies to long-term capital gains), whereas REIT dividends are generally not eligible for the reduced rates on qualified dividend income and are thus subject to tax at rates as high as 39.6 percent.³⁴ Similarly, corporate shareholders can generally claim a deduction for a portion of the dividend income that they receive from a regular C corporation but generally cannot deduct any portion of a REIT’s dividends.³⁵ And although REITs can often be very tax-efficient investment vehicles for other special classes of investors, such as foreigners and tax-exempt entities, a C corporation is sometimes better.³⁶

The gamut of REIT pros, cons and other considerations is too extensive to explore in detail here. Suffice it to say that the dividends paid deduction and the other benefits of REIT status, though powerful, must be weighed against other very fact-specific considerations. REITs are thus often a good way to invest in real estate, but in many cases a partnership or a C corporation will be a better investment vehicle.

B. Requirements to Qualify as a REIT

Our previous discussion of the drawbacks of REIT status omitted perhaps the most significant one: in order to qualify for the benefits of being a REIT, an entity must satisfy numerous requirements that, as a practical matter, may make it impossible to simultaneously qualify as a REIT and pursue an optimal business model. This Part outlines these requirements, which relate to, among other things, the nature of the REIT’s assets, the nature of the REIT’s income, the REIT’s distribution levels, the level of concentration in the ownership of the REIT and certain other organizational matters.

1. Asset Tests

The REIT asset tests, which are generally tested at the end of each quarter of the REIT’s tax year, ensure that

most of a REIT's assets consist of real estate–related assets and certain other mutual-fund-type investments. Most importantly, at least 75 percent of a REIT's assets must consist of cash and cash items, U.S. government securities and “real estate assets,”³⁷ a term that includes actual real estate (*e.g.*, land, buildings and certain other permanent structures), as well as loans secured by mortgages on real estate³⁸ (the “75-percent asset test”).

In addition to the 75-percent asset test, a set of other tests limits the amount of the securities that a REIT may own of a single issuer, relative both to the REIT's total assets and to the outstanding securities of that issuer. In particular, no more than 5 percent of a REIT's assets can consist of the securities of a single issuer³⁹ (the “5-percent asset test”), and a REIT may not own more than 10 percent (by vote or value) of the outstanding securities of any issuer (the “10-percent asset test”).⁴⁰ Securities that qualify for the 75-percent asset test (*e.g.*, U.S. government securities or debt securities secured by mortgages on real property), as well as securities of “taxable REIT subsidiaries” (TRSs),⁴¹ are not subject to the 5-percent and 10-percent asset tests.

The 5-percent asset test can be explained as a measure to protect investors against concentration risk: if a REIT invests too much of its assets in a single company, a downturn in the fortunes of that company will significantly hurt the value of the REIT's—and therefore its shareholders'—overall portfolio. Congress presumably thought that it was inappropriate to bestow a dividends paid deduction on entities that take those kinds of risks.⁴² But the 10-percent asset test—which applies regardless of how small the relevant issuer is, meaning that a \$100 billion REIT could fail to be a REIT by owning too much of a \$10,000 company⁴³—cannot be explained on investor-protection grounds. Instead, consistent with at least one view of the original policy objectives of the corporate tax, as described in Part III.B below, the 10-percent asset test appears to be a check on the power of a REIT's managers to influence other companies—a check that may be grounded in a fear of monopoly and other excessive corporate power.⁴⁴

2. Income Tests

There are two REIT income tests, both of which are tested on an annual basis. First, at least 75 percent of a REIT's annual gross income must come from certain real estate–related sources, including rents from real property, interest on real estate mortgages, gain from the sale of real estate or mortgages on real estate and dividends from other REITs (the “75-percent income test”).⁴⁵ Second, at least 95 percent of a REIT's annual gross income must

come from some combination of sources that qualify for the 75-percent income test and other (non-real estate) interest, dividends and gain from the sale of securities (the “95-percent income test”).⁴⁶

One aspect of the income tests is particularly worth mentioning: among the many limitations on what can qualify as “rents from real property” are a set of rules that limit the ability of a REIT to provide services to its tenants.⁴⁷ Under those rules, REITs can provide their tenants with “customary” services (examples of which may include utilities or common area maintenance), and the portion of the monthly rent payment that represents compensation for those services will be “good” income for both income tests.⁴⁸ But if a REIT provides noncustomary services (*e.g.*, maid service, valet parking) to a tenant, *all* of the rent from the tenant (even the portion that is for the use of space rather than services) will generally be treated as “bad” income for both income tests *unless* the services are furnished by a TRS or an independent contractor.⁴⁹

So, for example, if a REIT were to lease office space to a tenant for a fixed rental payment of \$1,000 a month, the REIT could provide the tenant with utilities, and all \$1,000 would be good income. Similarly, if the REIT were to provide the tenant with IT services (which we can assume would be treated as noncustomary) by hiring the REIT's wholly owned TRS to do the IT work for an arm's-length fee, all \$1,000 would likewise be good income (at the cost of a corporate-level tax paid by the TRS on its services fee). But if the REIT itself provided the IT services, all \$1,000 could be classified as bad income. The rules for services thus significantly restrict the ability of a REIT to earn income for its services (as distinguished from income for the use of space owned by the REIT), other than through taxpaying subsidiaries.

3. Special Rules for TRSs

Before summarizing the remaining REIT requirements, a brief detour is warranted. The topic is TRSs, which are highly relevant to both the income and the asset tests but not to the other requirements.

Most people think of REITs as “passive” investment vehicles (a label we eschew).⁵⁰ But the Code specifically allows REITs to engage in certain activities that some would describe as “active,” and REITs do this primarily through the use of TRSs.

A TRS is defined as any corporation that is owned in whole or in part by a REIT and that elects to be a TRS of the REIT.⁵¹ In other words, becoming a TRS is wholly elective, and so (with one exception noted below) there

are no operational requirements in order to be a TRS. As a result, a TRS can conduct almost any business or activity it wishes—whether related to the REIT’s rental operations (as in the case of a TRS that provides noncustomary services to the REIT’s tenants) or not. The only exception is that a TRS cannot operate or manage a lodging facility (e.g., a hotel) or a healthcare facility (e.g., a hospital).⁵² But everything else is fair game.

This “dividends paid deduction,” which is not available to most other corporations, allows a REIT to eliminate its corporate-level tax simply by distributing its net taxable income to its shareholders.

From a REIT’s perspective, TRSs are valuable primarily because, subject to the limitations described below, they can own assets and earn income that would otherwise be nonqualifying for purposes of the asset and income tests. Although the TRS structure can provide REITs with some flexibility, there are a number of limitations on a REIT’s ability to use a TRS. First of all, as their name implies, TRSs, as regular C corporations, pay regular corporate-level taxes on their income. This tax is, at a minimum, the price a REIT must pay in order to avail itself of the benefits of a TRS. And although a TRS may be capitalized with intercompany debt on which deductible interest is paid, the use of intercompany debt is limited in a number of respects, both by REIT-specific rules and by more general tax principles.⁵³

In addition to the tax cost of conducting activities through a TRS, the asset and income tests provide only so much room for TRS stock and dividends. For purposes of the asset tests, even though TRS stock is exempt from the 5-percent and 10-percent tests, it is not a qualifying asset for purposes of the 75-percent asset test. As a result, the stock of a TRS, together with any other nonqualifying assets, cannot represent more than 25 percent (beginning in 2018, 20 percent) of a REIT’s assets.⁵⁴ Similarly, for purposes of the income tests, dividends paid by a TRS are good income for the 95-percent income test but are bad income for the 75-percent income test. Again, this means that TRS dividends, together with all other sources of bad 75-percent income, cannot represent more than 25 percent of the REIT’s gross income.

TRSs thus allow REITs, at a tax cost, to participate in a limited amount of “non-REIT” business activities.

4. Distribution Requirements

Most people, when they think of the REIT requirements, think first of the income and asset tests. All other requirements, though important, are secondary. But as will soon become evident, the REIT distribution requirement may be the most important one from a corporate-tax-policy perspective.

Under that requirement, with limited exceptions, a REIT must distribute each year at least 90 percent of its net taxable income (other than long-term capital gains). Even though the distribution requirement permits a REIT to retain all of its long-term capital gains and up to 10 percent of its other REIT taxable income, the REIT must pay regular corporate-level taxes on any amounts that it does not distribute.⁵⁵ In practice, this means that most REITs seek to distribute all of their taxable income and gains, with the goal of completely eliminating any corporate-level taxes. This dynamic naturally limits a REIT’s ability to grow by reinvesting the money it earns, and, as a result, many REITs are dependent on new capital raises, in the form of periodic stock or debt offerings, in order to grow their businesses.

C. Special Rules for C-to-REIT Migrations

The final components of the REIT rules relevant to the current discussion are those dealing with REITs that were C corporations or that acquired assets from a C corporation in certain carryover-basis transactions. In those situations, two sets of rules come into play to ensure that the policy objectives underlying the REIT rules and the corporate tax do not conflict with one another. The first rule requires any REIT that succeeds to the E&P of a C corporation (including its own E&P for the period before it became a REIT) to distribute that E&P to shareholders before the end of the year.⁵⁶ The second rule imposes a corporate-level tax on the built-in gain inherent in any asset that a REIT owned on the day it converted from C corporation status or that the REIT acquired from a C corporation in a carryover-basis transaction, in each case to the extent that gain is recognized within five years of the REIT conversion or carryover basis transaction, as applicable.⁵⁷ The latter rule, which applies to S corporations and RICs as well, is designed to prevent REIT transactions from circumventing the repeal of the *General Utilities* doctrine.⁵⁸

III. The Policy Objectives of the Corporate Tax

The current debate on the proper taxation of REITs is premised on the notion that REITs should be subject

to the corporate tax in the first instance. This seems to lead REIT critics to two other views that are adverse to the REIT industry: that the REIT regime itself should be viewed as a narrow exception to the corporate tax and that any expansion of the REIT industry—whether through the development of new types of real estate, C-to-REIT conversions, or REIT spin-offs—represents an inappropriate exploitation of that narrow exception. In a system governed by logic, these two views disappear if their underlying premise—that REITs should be subject to the corporate tax as a policy matter—is shown to be false.

With regard to that premise, we were surprised to find that, as central a role as the corporate tax plays in our profession, there has been relatively little written on whether various provisions of the Code advance or hinder the historical policy objectives of the corporate tax or whether those objectives continue to be relevant.

This article seeks to ignite that debate with respect to the proper taxation of REITs. In laying out the historical policy objectives of the corporate tax, we have relied heavily on the work of Professors Reuven S. Avi-Yonah, Steven A. Bank and Marjorie E. Kornhauser,⁵⁹ who have each produced thorough articles on the history of the corporate tax. Although we have supplemented their research in places, we have found that their research provides as much detail as is available in the public record on the history of the corporate tax, and we are grateful for their contributions to our profession. The following in large part summarizes their work and uses their findings as the basis for the policy arguments in Part V and our policy recommendations in Part VI.

A. The History Behind the Corporate Tax

For reasons that will soon become clear, the scope and policy objectives of the corporate tax can be understood only in the broader historical context in which the corporate tax came into existence. In our country's first century, the only federal tax imposed on income came during the Civil War, when the proceeds from a variety of taxes were used to fund the Union's effort to win the war and then reconstruct the South in the postwar years.⁶⁰ This tax was allowed to expire in 1872.⁶¹

In short, our country had a strong bias against income taxation for the first century of its existence. So, how did a country that historically reviled the idea of a tax on income develop such a complex corporate income tax regime? The answer lies in the development of the corporation as a tool of industrial capitalism and the manner in which corporate behavior during the late 19th and early 20th

centuries affected public and policymakers' views on the need to regulate corporations.

As late as the 1850s, corporations were relatively rare, limited-purpose vehicles that were organized pursuant to the authority of specific state statutes.⁶² Beginning in the 1850s, however, states began to amend their laws to allow private citizens to form corporations to engage in commercial activity.⁶³ Initially, most corporations were closely held and owner-managed and consequently were viewed from a policy perspective as aggregates of their owners, much the same way as general partnerships were later viewed.⁶⁴

During the economic expansion of the mid-19th century, industry turned to the corporation as its entity of choice. The simple reason for this development was that corporations, unlike partnerships, possessed two attributes that made them ideal vehicles for operating large businesses, raising new debt and equity capital, and creating and acquiring new businesses: first, the owners of the corporation were not personally liable for debts and obligations of the corporation; and second, the corporation could be managed by a single group of people who were responsible for developing the business strategy and overseeing the day-to-day operations of the company and who had the discretion to decide whether to retain earnings or distribute them to shareholders.⁶⁵

The ability of a corporation's managers to retain earnings was central to the development of large industry, especially in the late 19th and early 20th centuries, for two reasons. First, retained earnings enabled corporations to deploy capital without having to seek additional funding from lenders or shareholders, and this flexibility provided corporations with tremendous advantages in the marketplace. In terms of operational flexibility, retained earnings enabled corporations to acquire new assets, develop new products and pursue innovation much more quickly than other businesses, which had to go to capital markets to fund those types of activities.⁶⁶ Second, and more significantly, retained earnings allowed corporations to quickly consolidate through mergers and acquisitions, which accelerated the development of industrial monopolies.⁶⁷ These monopolies were viewed as enabling corporations to raise prices above otherwise competitive levels, impose unfair terms on customers and other businesses and drive down real employee wages, all of which in turn could create more retained earnings, and so on.⁶⁸

It was around this time that the view of corporations held by the public and many policymakers began to shift.⁶⁹ Simply stated, a corporation that had thousands of shareholders (very few of whom had visibility into how the corporation was being managed and what the

corporation was doing on a day-to-day basis), possessed enormous amounts of money, employed tens or hundreds of thousands of people and operated with a nationwide supply, manufacturing and distribution chain stopped looking like an aggregate of individual owners and started to look like an entity separate from its owners.⁷⁰ This view was reinforced by the American public's growing concern (and not infrequent anger) over the amount of power wielded by the managers of the great industrial corporations, which power was viewed as having resulted from the unfair use of retained earnings.⁷¹

The outcry over this combination of monopolistic pricing and unfair trade practices, reinforced by the growing view that corporations were separate from their owners, reached a crescendo in the 1880s, leading to tremendous public pressure on Congress.⁷² Despite the support of public opinion, however, plotting a course of action proved extremely difficult.

It is hard for us today to imagine the hurdles that Congress faced in dealing with monopolies and unfair trade practices in the late 19th century. For example, if Congress were to decide tomorrow that it wanted to hold hearings that required the production of documents and the attendance of corporate executives, it would issue subpoenas commanding the production of documents and the attendance of those executives before Congress. Those executives would have two basic choices. First, they could produce the documents and appear before Congress. Second, they could spend some time in the Capitol jail for contempt of Congress and, after they got sick of the food and the accommodations, they could produce the documents and appear before Congress. Congress did not wield this type of power in the 19th century, and unless a recipient thought that he could obtain some sort of political advantage by responding to a congressional subpoena, he typically ignored it.⁷³

In the late 19th century, whatever power Congress possessed to curb monopoly and unfair trade practices was closely tied to its power to regulate interstate commerce. Although the scope of federal power under the commerce clause was relatively narrow in the late 19th century, Congress was able to enact the Sherman Antitrust Act in 1890 (the "Sherman Act"), which nominally authorized the executive branch to combat monopolies.⁷⁴

Ultimately, while the Sherman Act was undoubtedly a bold piece of federal legislation by 19th-century standards, it proved ineffective at reducing the power of the great industrial corporations of the day.⁷⁵ The potency of the Sherman Act suffered another blow when William McKinley prevailed over William Jennings Bryan in the presidential election of 1896. McKinley was in favor of the protective

tariffs that helped provide the industrial companies of the Northeast with pricing advantages, and his administration showed little interest in antitrust enforcement.⁷⁶ It might have been decades before antitrust enforcement received another Republican vetting were it not for McKinley's assassination in 1901 by the anarchist Leon Czolgosz at Buffalo, New York, after which McKinley's Vice President, Theodore Roosevelt, assumed the presidency.

President Roosevelt was part of the Republican Party's progressive wing, which held a more expansive view of federal power, and took the view that the power to tax could be used alongside the power to regulate interstate commerce in order to address the problems of monopoly power and unfair trade practices. The Roosevelt administration had some early successes on the antitrust enforcement front, bringing a number of antitrust suits which, among other things, led (eventually) to the breakup of the Standard Oil monopoly and the Northern Securities Company railroad monopoly.⁷⁷ President Roosevelt was less successful on the tax front, and that work was left to his successor, Howard Taft, who won the presidential election of 1908 and took office in March of 1909.

Initially, President Taft was opposed to the idea of a corporate tax because, among other things, he felt it might violate the Supreme Court's interpretation of the appointment clause, which had been used to invalidate an income tax act in 1895. The president's hand was forced soon after Taft's inauguration in 1909, when a number of Republicans from the western United States threatened to split the party in two if the Taft administration did not take action to curb the power of the Northeast industrial companies by reforming the tariff system and reducing the power of those companies through a corporate tax. To balance his jurisprudential concerns with his political concerns, President Taft agreed to back a corporate "excise tax" that was measured with respect to income, with the understanding that the parties would pursue a constitutional amendment authorizing an actual income tax.⁷⁸

B. Policy Objectives Underlying the Corporate Tax

With the political backdrop behind the 1909 corporate tax established, we turn to the policy objectives underlying that tax and its immediate successors. In that regard, it is important to bear in mind that, while the attributes of the corporate form and the practicalities of corporate business operations had led to a widespread view that corporations were separate from their owners, this development said nothing in and of itself as to whether corporations should be taxed. In other words, while the view of the corporation

as in some way separate from its shareholders supported the notion that corporations theoretically *could be taxed* separately from their owners, it did not establish whether or why, as a matter of policy, corporations *should be taxed*.

Those who dare to research U.S. tax law in the 19th and early 20th centuries will notice right away the absence of committee reports of any kind. To decipher why something was done, one must tease out policy objectives from the written statements of prominent politicians as well as news reports and commentary concerning the current events of the day. Unsurprisingly, then, scholars have taken different views on the policy objectives underlying the corporate tax. We describe those views here, in particular, the “regulatory” view of Professor Avi-Yonah and the “capital lock-in” view of Professor Bank.

1. The Regulatory View

Professor Avi-Yonah makes a compelling case that the primary policy objective underlying the 1909 corporate tax was to inhibit the creation of new monopolies and limit the development of existing monopolies, in two ways. First, the tax required corporations to file income tax returns, providing information to both the government and the public that had been previously hard to come by.⁷⁹ This information would allow the government to better enforce antitrust laws and grant the public greater visibility into the actions of large corporations. In the words of Senator Cummins, the wave of corporate consolidation in the late 19th and early 20th centuries was “simply a prelude to industrial commercial slavery unless the Government intervenes with its strong arm, and it can not intervene unless it has the information necessary to enable it to act intelligently and wisely.”⁸⁰ The idea here was simple: if the government could see what corporations were up to, it could identify and curtail bad behavior.

Second, and more significantly for our purposes, the corporate income tax limited the ability of corporations to retain their earnings. Congress viewed these retained earnings as the source of corporate power, which could be abused by creating monopolies and unfair trade practices. By limiting the ability of corporate managers to retain earnings, the corporate tax was viewed as a check on these abuses.

Both of these objectives are clear from the congressional record. Regarding the problem of retained earnings, Senator Robert L. Owen of Oklahoma remarked that “[t]he most important need of the people of the United States of this generation requires the abatement of the gigantic fortunes being piled up by successful monopoly . . . which have brought about a grossly inequitable distribution of the proceeds of human labor.”⁸¹ Senator Elihu Root of

New York, who was responsible for drafting the 1909 corporate tax, was quite clear as to its policy objective:

[I]t has so happened that in the development of the business of the United States the natural laws of trade have . . . put the greater part of the accumulated wealth of the country into the hands of corporations, so that when *we tax them we are imposing the tax upon the accumulated income and relieving the earnings of the men who are gaining a subsistence for their old age and for their families after them.*⁸²

Senator Albert Cummins of Iowa was a particularly ardent advocate of using the corporate tax as a way to protect the public against monopoly and urged a higher corporate tax on the great consolidators of the day:

[I]f a company is organized for the purpose of consolidating a dozen other companies with a view to controlling the business in which those companies are engaged for the purpose of being able to direct through a single board the management of the entire field of industry . . . it ought to be taxed at 10 or 15 per cent on the net earnings, that it ought to be taxed so heavily that such companies would become not only unfashionable but unprofitable as well.⁸³

These Senators’ statements, in Professor Avi-Yonah’s view, evidence Congress’s intent with the 1909 act to tax corporate retained earnings in order to limit corporate power.

Professor Avi-Yonah notes that the reasons behind the creation of the corporate tax explain how the tax came to exist but do not establish that the tax should in fact exist or that the tax serves a proper objective currently. Thus, in addition to laying out his views on the policy objectives underlying the corporate tax as expressed by Congress, Professor Avi-Yonah also offers a normative justification for that tax.⁸⁴ Put simply, in Professor Avi-Yonah’s view, the corporate tax should exist because it restrains the ability of corporate managers to wield power using other people’s money (*i.e.*, corporate retained earnings). Although a full articulation of Professor Avi-Yonah’s position, which would bring into play philosophical approaches to power and modern events, is beyond the scope of this article, it is interesting to note how the normative justifications for the corporate tax complement the policy arguments put forth by Congress in 1909.

2. The Capital Lock-In View

Professor Bank, like Professor Avi-Yonah, writes that the corporate tax as we know it owes its existence to the practice of corporations retaining increasingly large portions

of their earnings beginning in the late 19th century and extending through today. Professor Bank parts ways with Professor Avi-Yonah, however, on the reason why Congress wanted to tax those earnings.

Professor Bank attributes the existence of the corporate tax to the “capital lock-in” feature of corporations and politicians’ responses over time to that capital lock-in.⁸⁵ As Professor Bank uses the term, “capital lock-in” refers to two complementary features of the corporate form, both of which were critical to the development of late 19th and early 20th century industrial capitalism: the inability of shareholders to withdraw their capital from the corporation and the resulting ability of managers to retain corporate earnings to fund corporate-level expenditures.⁸⁶

The benefits and drawbacks of capital lock-in depend on one’s perspective. For corporate managers, capital lock-in is generally positive, as it enables corporate managers to pursue their objectives without having to return to the capital markets to raise new money and explain themselves.⁸⁷ For government, capital lock-in is generally negative to the extent it prevents the government from imposing an immediate shareholder-level tax on corporate profits. For shareholders, capital lock-in is a mixed bag: on the one hand, it prevents corporations from having to wind up if multiple shareholders demand the return of their capital at the same time (a “run” on the corporation); on the other hand, it imposes an opportunity cost on shareholders who cannot use retained corporate wealth to their own ends.⁸⁸

In Professor Bank’s view, while both the tax of the Revenue Act of 1894⁸⁹ and the 1909 corporate tax were aimed at taxing shareholders on their share of undistributed corporate earnings, both regimes reflected congressional unease with taxing corporate earnings *per se* (*i.e.*, rather than as a substitute for taxing distributions to shareholders). Thus, in the early years of the corporate tax (and after the passage of the Sixteenth Amendment and subsequent enactment of an individual income tax in 1913),⁹⁰ the government generally collected tax from corporations and then allowed shareholders to exclude from their own incomes any dividends attributable to income that was previously taxed at the corporate level.⁹¹

This exclusion, however, was only partial; as it is today, the individual tax under the Revenue Act of 1913 was progressive. At that time, corporations were subject to income tax at a rate of one percent and individuals were subject to two taxes—a “normal” income tax of one percent and a “sur tax” of up to six percent imposed at graduating rates.⁹² Individuals were entitled to exclude corporate dividends from income for purposes of calculating their “normal” tax liability but not for purposes of determining their surtax liability. Consequently, the 1913 corporate tax generally

provided for a single level of tax on corporate income, regardless of whether distributed; shareholders therefore had no “normal” tax-related reasons to prefer corporations to retain their earnings; whether distributed or not, corporate income was subject to a one-percent tax.⁹³

By contrast, the surtax provided a compelling reason for high-earning shareholders to prefer that corporations retain their earnings. Retained corporate income was subject to one-percent tax; corporate income distributed and subject to the surtax was subject to a total tax of seven-percent. Despite this incentive for tax deferral, policymakers in 1913 did not find it necessary to either force corporations to distribute their earnings or to subject high earners to tax on their share of a corporation’s retained earnings, perhaps because of the relatively small difference between corporate and surtax rates in 1913.⁹⁴

That view, according to Professor Bank, changed over time for three reasons. First, individual “normal” and surtax rates were raised substantially as a result of World War I, but corporate rates were not comparably raised, which increased the benefits of deferring shareholder-level taxation by having corporations retain their earnings.⁹⁵ Second, for reasons unrelated to taxation, as corporations grew larger, corporate managers decided to retain a larger portion of their earnings.⁹⁶ Third, the existence and growth of retained earnings, combined with the disparity in “normal” tax and surtax rates between shareholders and corporations, came to be viewed by policymakers as an unfair tax deferral mechanism for individual shareholders with high incomes.⁹⁷

Because Congress was still uncomfortable with the idea of taxing individual shareholders on their share of a corporation’s retained earnings, this development spawned a contentious struggle between the government and corporate managers over shareholder tax deferral and retained earnings.⁹⁸ The two sides in this struggle staked out relatively simple positions on retained earnings: The government wanted more revenue from high earners in order to do what it needed to do, and corporate managers wanted to retain as much of their corporations’ earnings as possible in order to do what they needed to do.⁹⁹

After a decades-long legislative struggle that lasted through the presidency of Harry S. Truman, the government and corporate managers reached what could best be described as a political settlement: The government would increase the corporate tax rate as a proxy for taxing shareholders’ collective accessions to wealth, and managers would keep their ability to retain earnings. In this sense, the corporate tax can be thought of as a rough-justice shareholder-level anti-deferral regime, similar conceptually to the current regime that applies to passive foreign investment companies.¹⁰⁰

When it comes to the relationship between shareholders and corporate managers, the logical implication of Professor Bank's account of the corporate tax is rather stark: The corporate tax can be seen as the amount of shareholder wealth that corporate managers are willing to surrender to the government in order to have the power to deploy what is left.¹⁰¹ The starkness of this view is reflected in discussions of the agency cost problem of retained earnings, many of which have been led by Professor Bank. Although a discussion of those problems is beyond the scope of this article, the problem boils down to the fact that, when it comes to corporate profits, corporate managers and shareholders have conflicting interests, insofar as shareholders would like to receive as much in the way of dividends as possible and corporate managers would like to retain as much in the way of earnings as possible.¹⁰²

C. Either Way, the Corporate Tax Is About Retained Earnings

Professors Avi-Yonah and Bank present compelling arguments in support of their positions. That said, when we found two prominent law professors advocating competing views on the policy objectives underlying the corporate tax, we found ourselves ruminating over that ancient Swahili proverb—when elephants jostle, it is the grass that suffers.

The best way to avoid getting crushed is to take to the trees, and on that score we were relieved to find that we need not decide which position to adopt for purposes of this article. The crux of each scholar's position is that the purpose of the corporate tax is to enable the government, for one reason or another, to use its taxing power to relieve corporations of some portion of their retained earnings. In other words, regardless of which scholar one chooses to follow, one is led back to the same place—the policy objective underlying the corporate tax involves the government's desire to confiscate a portion of corporations' retained earnings. Furthermore, the position taken by each scholar, although grounded in the events of the late 19th and early 20th centuries, resonates to this day.

With respect to Professor Avi-Yonah's views on the role of the corporate tax in seeking to limit the power of corporate managers, we think that these policy objectives are still relevant today. While a discussion of antitrust enforcement and the deleterious effects of monopolies and unfair trade practices is beyond the scope of this article, it does bear mentioning that significant sectors of our economy are dominated by a small number of companies, and while we might not face constant oppression by monopolists, we do experience as a society some harmful effects from the

power that corporate managers wield as a result of having control over vast amounts of retained earnings. Because the corporate tax represents an appreciable drag on the growth of retained earnings, it also represents an appreciable drag on the growth of the power of corporate managers, and this drag becomes especially impactful when the effects of the corporate tax compound over time. While the corporate tax cannot be the sole instrument through which corporations are regulated, it is to this day one of many tools in the tool box, and one that we believe is as relevant today as it was in 1909.

Turning to Professor Bank's view that the corporate tax represents a kind of charge paid by managers to retain corporate earnings, we note that some aspects of Professor Bank's view—specifically his recounting of how corporate managers of the late 1930s and early 1940s used corporate funds to lobby against the undistributed profits tax—illustrate the way in which corporate managers are willing to surrender a portion of shareholder wealth in order to retain control over the remainder of that wealth.

If it seems as though we are endorsing both Professor Avi-Yonah's and Professor Bank's views, it is because we find both of their accounts compelling and, furthermore, think it likely that both Professor Avi-Yonah's regulatory view and Professor Bank's capital lock-in view were correct during certain periods of time, with the regulatory view at some point (probably in the late 1930s) beginning to yield to the capital lock-in view. That said, Professor Avi-Yonah's view that the normative power of the corporate tax lies in its ability to reduce the power of corporate managers at the societal level transcends time periods and would apply with the same force today as it did in 1909.

As discussed below, the point of primary relevance to the REIT context is retained earnings. On that score, regardless of which scholar's view one accepts, the conclusion is the same: the corporate tax is all about the government reducing retained corporate earnings.

IV. Historic Development of REITs in Our Tax System

A. The Back-Story: Why REITs Needed Tax Legislation in 1960

The current debate on the proper taxation of REITs is premised on the notion that REITs should be subject to the corporate tax in the first instance. As discussed in Part V, we think that premise is false.

This Part IV focuses on the intellectual foundation underlying that false premise: the "corporate resemblance

test.” This test was used to classify as a corporation any unincorporated entity that looked too much like a corporation and not enough like a noncorporation. Although the test sounds silly and proved disastrous in practice, it existed in one form or another for over seven decades until, after having been discredited intellectually, it was discarded by the government and replaced with the check-the-box regulations in 1997.¹⁰³

Although the corporate resemblance test and its underlying authorities never made sense from a tax policy perspective and have been dead for two decades, they somehow continue to provide the sole intellectual support for the premise that, as a matter of tax policy, REITs should be subject to the corporate tax in the first instance. Given the enduring nature of what we can best describe as a conceptual weed, we feel compelled to explain in gory detail the history of the corporate resemblance test; how disastrous that test proved for both the government and taxpayers; the reasons why that test did not advance the policy objectives underlying the corporate tax; and, perhaps more importantly, the reasons why that test actually prevented those policy objectives from being fully realized.

Seasoned members of our profession, for whom the corporate resemblance test may be an unfortunate but vivid memory, might wish to focus exclusively on Part IV.A.2(d), which addresses the tax policy shortcomings of the corporate resemblance test, and Part IV.A.3, which addresses a number of aspects of the Revenue Act of 1936 that are relevant to the current policy debate on the proper taxation of REITs. Those who desire detail might wish to take a sip of coffee before reading on.

1. The Early Development of Collective Investment Vehicles

In the 19th and early 20th centuries, real estate sponsors and investors faced a conundrum that inhibited the formation of widely held real estate investment vehicles: Although corporations existed and shielded shareholders from liability for debts and obligations of the corporation, corporations, generally speaking, could not own real estate as a matter of corporate law,¹⁰⁴ and although general partnerships could own real estate, the partners were personally liable for the debts of the partnership.¹⁰⁵ The need for a limited liability entity that could own real estate was fulfilled by the State of Massachusetts’s recognition of a “business trust,” which was a creature of contract law that provided for limited liability in its trust documents, as recognized in *Attorney General v. Proprietors of the Meetinghouse* in 1854.¹⁰⁶

The Massachusetts business trust soon became the nation’s first trust for real estate investment—quite literally

a real estate investment trust—and Massachusetts real estate investment trusts were used to pool money from a large number of investors in order to develop and own real estate projects in Detroit, Chicago, Minneapolis, St. Paul, Kansas City, Omaha, Milwaukee, San Francisco, Duluth, Denver and Seattle.¹⁰⁷

Investment managers soon found that the investing public had an appetite for collective investment vehicles and that this appetite extended to stocks and other securities.¹⁰⁸ In trying to structure a collective investment vehicle for stocks and securities, managers ran into the same problem faced by sponsors of real estate investment trusts—under the law as it existed in the 19th century, one corporation could not own stock in another,¹⁰⁹ and general partnerships were not appropriate vehicles for pooled investment due to issues around unlimited liability, governance and continuity of life. These managers reached the same conclusion as their counterparts in the real estate industry—Massachusetts trusts were the only viable vehicle for collective investment in stocks and securities. These trusts were referred to in their early years as “mutual investment companies,” and the Massachusetts trust mutual investment company evolved into today’s RIC.¹¹⁰

2. REITs and the “Corporate Resemblance Test” Debacle

(a) A “Fearful Bungle” Sets the Stage for a Debacle.

Interestingly, although the corporate resemblance test is a product of courts’ interpretation of the 1913 corporate tax, its immediate successors, and the related Treasury regulations, the history behind the corporate resemblance test begins in 1894, when Congress enacted what amounted to an income tax on individual corporate shareholders that was to be collected by the corporations in which those individuals owned stock. (That tax was struck down as unconstitutional in 1895.)¹¹¹ As it was drafting the language for the Revenue Act of 1894, Congress became concerned that business entities that did not go by the name “corporation” but were otherwise similar to corporations might avoid the new tax.¹¹²

To address this concern, Congress included both “companies” and “associations” as the types of entities that would be brought into the corporate tax base under the 1894 act. State law generally did not define “associations” (although Senator George G. Vest of Kentucky mentioned “building and loan associations” as an example),¹¹³ and Congress did not define the term. This left the scope of the corporate tax itself undefined and conceptually unclear, a result which prompted Senator William Chandler to reach the following, remarkably prescient, conclusion:

The clause [defining the scope of the tax] is a fearful bungle, and it ought to have, if it passes, a special title to it, and that is “[a] clause to increase the fees of lawyers,” because there will be more litigation and more large fees in connection with this wonderful discovery, invention, contrivance, and construction ... than ever have been known before in connection with any tax law passed by this Government. [T]here never was a more loosely drawn, inaccurate, and, I was about to say, impotent taxation clause submitted to a legislative body¹¹⁴

The Supreme Court ruled that the 1894 tax violated the apportionment clause, which required that income taxes be apportioned among the citizens of the various states based on population.¹¹⁵ Because income and wealth were spread so unevenly, the tax could not satisfy that standard.

With the 1894 tax a nullity, the problem of the scope of the “corporate” tax lay dormant until the lead-up to the 1909 corporate tax. Congress once again faced the question that led to the “fearful bungle” of 1894: Should the corporate tax be limited to entities that are actually incorporated under state law, or should the tax also apply to other entities that implicate the law’s policy objectives?

In working through this question, Congress was walking a tightrope. The Supreme Court had struck down the 1894 tax on apportionment clause grounds, and the Sixteenth Amendment was merely a twinkle in President Taft’s eye. Congress was careful to style the 1909 corporate tax as an “excise tax” on the act of doing business, even though the tax was computed with reference to income.¹¹⁶ Legislators hoped that the “excise tax” language would avoid the apportionment clause problem.¹¹⁷

Although they might have side-stepped the apportionment clause problem, legislators struggled with a related constitutional question: Were corporations “natural entities” under the law or were they “artificial entities”? Put differently, were corporations natural persons who possessed constitutional rights of their own accord, or were they instead creatures of law, bereft of constitutional rights and possessing only those rights granted to them by legislatures? If corporations were natural persons with constitutional rights, then they might be able to challenge the 1909 corporate tax on the theory that it was unfair to tax corporate persons without also taxing noncorporate persons. If corporations were artificial creatures of law, then they could be taxed differently than natural persons or other entities. In legislators’ eyes, the answer to this question went straight to the constitutionality of the corporate tax, and the answer itself affected the definition of the term “corporation.”¹¹⁸

Eventually, the legal community would reach a consensus that corporations were “natural entities.” In the first decade of the 1900s, however, the debate between the “natural” and “artificial” theories was at its height.¹¹⁹ The debate involved aspects of philosophy, legal theory and constitutional theory, and legislators held differing views on the topic.¹²⁰

These facts lay the groundwork for four simple conclusions. First, in light of the policy objectives underlying the corporate tax, REITs should never have been subject to the corporate tax.

As one might expect from a group of legislators facing a difficult philosophical, legal and constitutional question that went straight to the viability of the statute on which they were working—they punted. Congress adopted a provision applying the 1909 corporate tax to every “corporation, joint stock company or association, organized for profit ... under the laws of the United States or any state ... and engaged in business,” and left the terms “joint stock company” and “association” undefined.¹²¹

We understand why Congress punted on the definition of “corporation” in 1909. The public was demanding action against the monopolists and Congress felt compelled to enact legislation. In that environment, it would seem completely reasonable for Congress to conclude that it was better to have a provision that no one understood than to have no provision at all. Nonetheless, inaction has its consequences, and in this case, congressional inaction on the definition of “corporation” in 1909 allowed the fearful bungle of 1894 to resurface, resulting in a seemingly uninterrupted, 80-year long string of court cases, legislative amendments, administrative regulations, rewritten regulations, amended regulations, withdrawn regulations, revenue rulings, amended revenue rulings and withdrawn revenue rulings that collectively represent one of the saddest and perhaps most embarrassing debacles ever produced by our tax system.

Although we are confident that this debacle would bring a wry smile to the face of the late Senator Chandler, it continues to create perception problems for the entire REIT industry and in fact forms the key premise of a tax debate that has the potential to threaten the very existence of the industry. While the entire episode could consume

a book, this article will provide a brief sketch of how the episode affected REITs.

(b) Entity Classification in the Early Years. From the perspective of the REIT industry, the trouble around the tax classification of unincorporated entities began almost as soon as the 1909 corporate tax was enacted. To put it bluntly, despite the fact that Congress and the Taft administration pushed for the enactment of the corporate tax to address the accumulation of corporate retained earnings, the Treasury and the Bureau of Internal Revenue set about attempting to subject to the corporate tax seemingly every type of business entity other than sole proprietorships and certain general partnerships, with scant reference to retained earnings.

For example, almost immediately after the enactment of the 1909 corporate tax, the Bureau went after the Cushing Real Estate Trust, which was “formed for the purpose of purchasing, improving, holding, and selling lands and buildings in Boston,” and attempted to subject it to tax as a corporation.¹²² This led to *Eliot v. Freeman*, where the Supreme Court held that the Cushing REIT could not be subjected to the corporate tax because, like other Massachusetts business trusts, it was a creature of common law and thus not “organized . . . under the laws of the United States or any states,” as required by the 1909 Act.¹²³

Prior to the enactment of the 1939 Code, each successive revenue act—in 1913,¹²⁴ 1916,¹²⁵ 1917,¹²⁶ 1918,¹²⁷ 1921¹²⁸—essentially constituted a complete rewriting of the tax code, and Treasury issued regulations pursuant to most of these acts. This process led to constant revisions of statutory and regulatory language, often without explanation, with predictably unpredictable results.

For example, the Revenue Act of 1913 (the “1913 Act”) amended the corporate tax to bring within its scope every “corporation, joint stock company or association . . . organized in the United States . . . no matter how created or organized.”¹²⁹ Although this amendment undercut the Court’s reasoning in *Eliot*, the 1913 Act remained ambiguous with respect to the taxation of Massachusetts business trusts, as it was unclear if the trusts fell within the definition of “association” under the Act.

The Supreme Court first addressed this question in *Crocker v. Malley*.¹³⁰ This case involved a trust that owned a number of mills that were leased to a corporate subsidiary of the trust. The Bureau sought to tax the trust both on the dividends from the stock and the rent from the mill; to put it in modern terms, the Bureau sought to tax the trust both in its role as a regulated investment company (RIC) and REIT. The Court held for the taxpayer, concluding that the REIT did “not fall under any familiar conception of a joint-stock association.”¹³¹

The Court’s holding followed two lines of analysis, one a technical argument grounded in common law and one policy-based. As a matter of common law, the Court rejected the Bureau’s contention that the trustees and beneficiaries should be grouped together as associates engaged in a joint business venture. There was a crucial distinction between beneficiaries and trustees, in that the trustees, not the beneficiaries, had control over the trust, and the Court could “perceive no ground for grouping the two—beneficiaries and trustees—together in order to turn them into an association by uniting their contrasted functions and powers although they are in no proper sense associated.” Treating REITs as corporations would, in the words of the Court, “be an unnatural perversion of a well-known institution of the law.”¹³²

On policy grounds, one of the more interesting aspects of the *Crocker* decision was that it represented one of the few instances we have found in which the Court considered the policy objectives underlying the corporate tax in analyzing whether an unincorporated entity should be subject to that tax. With regard to the leased mills, the Court noted:

The function of the trustees is not to manage the mills [that were being leased to the corporation], but simply to collect the rents and income of such property as may be in their hands, with a large discretion in the application of it, but with a recognition that the receipt holders are entitled to it subject to the exercise of the powers confided to the trustees. *In fact, the whole income, less taxes and similar expenses, has been paid over in due proportion to the holders of the receipts.* There can be little doubt that, in Massachusetts, this arrangement would be held to create a trust, and nothing more.¹³³

With regard to the dividends received from the REIT’s corporate subsidiary, the Court noted:

We presume that the taxation of corporations and joint-stock companies upon dividends of corporations that themselves pay the income tax *was for the purpose of discouraging combinations of the kind now in disfavor [i.e., monopolies], by which a corporation holds controlling interests in other corporations which, in their turn, may control.* There is nothing of that sort here.¹³⁴

Put simply, the Court viewed the trust as a conduit entity for collective investment, and not as an entity that retained its earnings or operated in a way that created concerns around monopoly or retained earnings. Because

the trust was not the type of entity that implicated the policy objectives underlying the corporate tax, the Court refused to classify the trust as an association that was subject to that tax.¹³⁵

Interestingly, Treasury reflected this view when it issued Reg. 45, Article 1502 under the Revenue Act of 1918 (published in 1919, after *Crocker* was decided), which provided in part that:

Where ... the interest of each beneficiary in the income of trust property, as received, belongs to him as his separate, individual property, and *the trustee is required to make prompt distribution of it* and is not responsible for the operation of the property from which it is derived, the trustee and the cestuis que trust do not constitute and association.¹³⁶

Additionally, following *Crocker's* common law rationale, these regulations provided that a trust would be subject to the corporate tax if the beneficiaries “have a voice in the conduct of the business of the trust.”¹³⁷ The clarity of this “control test” rule enabled the lower courts to hold, in every case of which we are aware, that a REIT was not subject to the corporate tax, as long as the beneficiaries did not exercise control over the trust.¹³⁸

(c) Entity Classification from the 1920s to the Great Depression. Whatever clarity *Crocker* provided was short-lived. In *Hecht v. Malley*, the Supreme Court held that a REIT that held office property in Boston was a taxable association on the grounds that the trustees were “associated together *in much the same manner* as the directors in a corporation for the purpose of carrying on business enterprises.”¹³⁹

The statement in the *Hecht* opinion that a trust which operates “in much the same manner” as a corporation can be taxed as a corporation eventually led to the debacle that we all know as the corporate resemblance test.¹⁴⁰ The Treasury reacted to this expansive criterion for taxation almost immediately after *Hecht* was decided, with the Bureau attempting to tax trusts as corporations. The government won some cases and lost some cases, and seemed to amend the regulations regardless of whether it won or lost. When it won, the government seemed to amend the regulations to include judicial theories it had not previously advanced, and when it lost, the government seemed to amend the regulations to include theories that might have helped it win.¹⁴¹ The end result—regulations issued in 1926,¹⁴² 1928,¹⁴³ 1932¹⁴⁴ and 1934¹⁴⁵ attempting to distinguish between a narrow set of trusts that would continue to be taxed as trusts and a broadly defined set of trusts that would be taxed as corporations—can best

be described as a game of regulatory “whack-a-mole,” and the game was as ugly and frustrating for the participants as it is for all of us.¹⁴⁶ Commentators of the period noted that “harassed district courts have referred to the [definition of association after *Hecht*] as a ‘troublesome subject’ and a ‘vexed question,’”¹⁴⁷ and that a Bureau of Internal Revenue attorney had, in 1935, “expressed the unofficial opinion that the decisions ‘determining what constitutes an association within the meaning of the statute, bewilder rather than enlighten.’”¹⁴⁸

This brings us to the seminal 1935 decision of the Supreme Court in *T.A. Morrissey*,¹⁴⁹ which concerned the application of the 1934 entity classification regulations on the tax classification of trusts. Although *Morrissey* is undoubtedly influential—it remained quoted in entity-classification Treasury Regulations until 1997¹⁵⁰—we view *Morrissey* not as a product of careful judicial analysis but as a judicial surrender to the Treasury’s endless amendments to our entity classification system.

The *Morrissey* case involved a REIT that engaged in the construction and operation of golf courses and the development of land for sale. In holding that the REIT was an association taxable as a corporation, the court articulated five characteristics of corporate status that, if found in a business trust, indicated that the trust should be treated as a taxable association: (i) the ability of the trust to hold title to property; (ii) survival of the trust beyond the death of its beneficiaries (“continuity of life”); (iii) centralized management by trustees, who act similarly to corporate directors; (iv) freely transferable ownership interests (“free transferability”); and (v) limited liability.¹⁵¹ This five-factor corporate resemblance test was reinforced by three other cases in the Court’s 1935 term: *Swanson*,¹⁵² *Helvering v. Combs*,¹⁵³ and *Helvering v. Coleman-Gilbert Associates*.¹⁵⁴ As these characteristics were found in most Massachusetts business trusts, the passthrough taxation that those trusts had enjoyed was effectively at an end.

Returning to our view of *Morrissey* as a judicial surrender to a relentless administrative process, perhaps the most important feature of the decision lies not in its articulation of a corporate resemblance test—the Court essentially adopted factors already present in Treasury regulations promulgated after *Hecht*¹⁵⁵—but the extreme deference it gave to Treasury in defining the term “association.”¹⁵⁶ The Court’s reasoning was straightforward enough: Because the Revenue Act of 1918 stated, without further definition, that the term “corporation” includes “associations,” the Court felt that Congress had effectively delegated the definition of “association” to Treasury.¹⁵⁷

In our view, this interpretation of the 1918 Act cannot fully explain the level of deference given by the Court to

the Treasury. For example, key words used to define the scope of a “corporate” tax were not defined in the 1909 tax, nor were they defined in any of the revenue acts that followed, yet the courts took it upon themselves to interpret those words, sometimes taking into account the policy objectives underlying the corporate tax (most notably in *Crocker*). Deference to the Treasury was not the dispositive judicial position on the tax classification of unincorporated entities until *Morrissey*, hence our view of *Morrissey* as a judicial surrender to a relentless administrative process. Although we are not huge fans of surrender, we note that in this instance surrender provided significant benefits—as far as we can tell, *Morrissey* was the last significant entity classification case decided by the Supreme Court.

(d) The Policy Problem with the Corporate Resemblance Test. From a tax policy perspective, the corporate resemblance test posed two huge problems. First, the test was completely divorced from the policy objectives underlying the corporate tax. Second, by classifying RICs and REITs as corporations for tax purposes, the test actually prevented those policy objectives from being fully achieved.

The key to understanding the first problem is that the corporate resemblance test merely recites the attributes relied upon by scholars and policymakers to validate the “natural entity” theory of the corporation, which in turn is used to justify the treatment of a corporation as a natural person with rights and protections under the law *in general*.¹⁵⁸ The natural entity theory says little about which rights a corporation possesses, and nothing about rules should apply to corporations or how those rules should be applied.

In the context of tax policy, the attributes of “corporateness” underlying the natural entity theory contributed to the notion that corporations *could be treated* as entities separate from their shareholders, meaning that corporations *could be taxed*. But these attributes, in and of themselves, provided no guidance on whether corporations or other entities that shared some or all of these attributes *should be taxed*. In order to determine whether an entity that theoretically *could be taxed* separately from its owners in fact *should be taxed*, Congress itself needed a policy objective for the imposition of the tax. In this case, depending on whether one adopts the regulatory view or the capital lock-in view, Congress enacted the corporate tax either to limit the accumulation of retained earnings that could be used to pursue monopolistic or unfair trade practices or to impose an indirect tax on shareholders’ accession to wealth. Regardless of which view one follows, the existence of retained earnings, or at the very least the existence of the ability to retain earnings, is the *sine qua non* of corporate taxability.¹⁵⁹

Thus, throughout the early 20th century, the legislative history underlying the various corporate tax acts indicates a congressional policy aimed at corporate retained earnings. The various regulatory iterations of the corporate resemblance test simply ignore that policy focus. In fact, throughout the history of the corporate resemblance test, the regulations completely ignored the distinction between the question of whether an entity *could be taxed* and the question of whether an entity *should be taxed*. Instead, the regulations simply adopted the position that *every entity which could be taxed must be taxed*. Thus, under the corporate resemblance test, every entity that theoretically could be taxed was subject to tax as a corporation regardless of whether the entity was able or likely to retain its earnings and thereby implicate the policy objectives underlying the corporate tax. The regulations were simply divorced from the policy objectives underlying the corporate tax.

More importantly, the corporate resemblance test, by classifying collective investment vehicles such as RICs and REITs as corporations, actually prevented the policy objectives underlying the corporate tax from being fully realized. When it enacted the corporate tax in 1909, Congress was heavily focused on retained earnings.¹⁶⁰ Reflecting that focus, Congress allowed a corporation to deduct interest paid to lenders, which has been justified on the grounds that debt service payments inhibit the growth of retained earnings.¹⁶¹ From the perspective of corporate tax policy, when a REIT owns property that it leases to a corporate tenant, it is performing the same basic function as a lender, insofar as the payment of rent prevents the accumulation of retained earnings by the corporate tenant. By preventing REITs from performing this function, the corporate resemblance test may have actually stymied the policy objectives underlying the corporate tax.

This result was not inevitable. If Treasury had wanted to adopt a corporate resemblance test for administrative convenience while remaining true to the policy objectives underlying the corporate tax, it could have adopted a single factor test: whether the entity’s charter documents provided for a centralized management team that possessed the power to retain earnings and to deploy those retained earnings without further input from owners. If the managers of an unincorporated entity were required by the entity’s charter documents to distribute earnings on a regular basis, the entity did not implicate the policy objectives underlying the corporate tax and should never have been classified as a corporation.

(e) The Corporate Resemblance Test Debacle: From *Morrissey* to *Check-the-Box*. After *Morrissey*, the corporate resemblance test morphed from a policy problem plaguing the REIT industry into a debacle that affected

American business more generally. The IRS's general approach was to uniformly expand the application of the corporate resemblance test (without regard to the policies underlying the corporate tax) but, where this expansion produced results the IRS did not like, create incoherent exceptions to the test.

For example, the IRS decided to go after doctors, who, by the 1930s, had begun banding together into larger medical practices. The first doctor to enjoy some attention from the IRS was Dr. Pelton, who had participated in a medical clinic that was organized in trust form to provide limited liability.¹⁶² The Seventh Circuit classified the medical practice as a corporation for tax purposes in a two paragraph opinion that relied on *Morrissey*. This is an astounding example of just how divorced the corporate resemblance test was from the policy objectives underlying the corporate tax.

Policy disconnects notwithstanding, things seemed to be going well for the IRS and poorly for taxpaying physicians until a clever doctor by the name of Arthur Kintner figured out how to obtain an above-the-line tax deduction for every dollar that he saved toward retirement and, in addition, tax-deferred growth of all funds held in the retirement account.¹⁶³ The strategy was amazingly simple: Dr. Kintner and his medical partners caused their medical practice to become classified as a corporation under the corporate resemblance test and the *Pelton* case. Once that was done, the medical practice established a tax-deductible qualified pension plan for the shareholder/employees and *voilà*—the tax-deductible, tax-deferred bank account was born, courtesy of the corporate resemblance test.

The IRS's reaction demonstrated the growing fiasco of the corporate resemblance test—after having issued a set of anti-taxpayer regulations and prevailing against a similarly situated taxpayer on those same regulations, the IRS tried to challenge its own regulations as being unfair to the government.¹⁶⁴ Not surprisingly, the courts held the IRS to the regime it had created and classified Dr. Kintner's medical practice as a corporation. Dr. Kintner got his tax-favored savings account, and the IRS got a black eye in the process.

The IRS's response to *Kintner* was Rev. Rul. 56-23,¹⁶⁵ in which the IRS stated that a group of professionals who created a "corporation" within the meaning of the corporate resemblance test and proceeded to establish a pension plan for themselves would instead be treated as having formed a partnership for tax purposes, which could not take advantage of the pension strategy. Basically, the corporate resemblance test would continue to apply to all entities, including professional service entities, unless, in the case of a professional services entity only, the entity

tried to establish a pension plan. The establishment of a pension plan thus became a "super noncorporate factor" in determining whether the corporate resemblance test was satisfied. At some point, someone inside the IRS began to grasp the utter ridiculousness of that position and issued Rev. Rul. 57-546,¹⁶⁶ which "modified" Rev. Rul. 56-23 and directed the IRS to apply the corporate resemblance test to a professional service entity even if the entity established a pension plan.

The *Kintner* case and the process that produced Rev. Rul. 56-23 and Rev. Rul. 57-546 led the IRS to reevaluate its entity classification regulations, and the end result was former Reg. §301.7701-2, nicknamed, appropriately, the "Kintner Regulations."¹⁶⁷ Under this iteration of the corporate resemblance test, an unincorporated entity would be subject to tax as a corporation if it possessed a preponderance of the following six factors: (i) associates; (ii) an objective to carry on a business and distribute profits; (iii) continuity of life; (iv) centralized management; (v) limited liability; and (vi) free transferability of interests. Because any multi-member entity that was engaged in commerce would satisfy the first two requirements, an unincorporated entity would be subject to tax as a corporation if it possessed at least two of the four remaining characteristics.

Returning to our debacle, a taxpayer might have reasonably thought that, when the IRS issued Rev. Rul. 57-546, it had moved past its preoccupation with doctors with pension plans and had learned to live with the results produced by the corporate resemblance test it had championed in one form or another for at least three decades. That taxpayer would have been sadly mistaken, as the IRS inserted into the new regulations a special rule designed to prevent professional services firms from being classified as corporations for tax purposes. The special rule provided that a general partnership organized under the Uniform Partnership Act—essentially all state law partnerships—could not be classified as a corporation for tax purposes even if it had a preponderance of the other corporate factors.¹⁶⁸ Because state laws at the time required medical practices to be formed as general partnerships, the IRS thought that this new rule would forever solve the problem of doctors with pension plans. Unfortunately for the IRS, the battle over the tax classification of medical practices was only beginning: soon after the new regulations were issued, states began allowing doctors to form their own professional corporations, and the practice of doctors with pension plans was back in vogue.

When states amended their corporate statutes to permit doctors to conduct their medical practices through state law corporations,¹⁶⁹ they seemed to have used the corporate resemblance test to paint the IRS into a corner, insofar

as state law professional corporations would certainly seem to resemble corporations for tax purposes. In fact, we would have thought it impossible to imagine a situation in which a state law corporation does not resemble a corporation.

The IRS's imagination during the 1960s was far better than ours—in 1965, the IRS issued proposed amendments to the Kintner Regulations in order to make sure that a medical practice, whether or not formed as a professional corporation under state law, could not be classified as a corporation for tax purposes.¹⁷⁰ Generally speaking, the amendments made it almost impossible for a state law medical services corporation to satisfy the definitions of “centralized management” and “limited liability,” which would have prevented the corporation from possessing a preponderance of the corporate factors.¹⁷¹

At this point, the debacle became almost surreal: the IRS expected courts to defer to its view that a narrow class of state law corporations did not resemble corporations and pursued a number of taxpayers who were brave enough to disagree. The courts refused to accept the IRS's argument that a corporation did not resemble a corporation and invalidated the amendments on the grounds that they were “arbitrary and discriminatory.”¹⁷² Unlike its purported surrender in Rev. Rul. 57-546, the IRS's surrender this time was genuine; it issued Rev. Rul. 70-101,¹⁷³ which permitted professional corporations to be treated as corporations for tax purposes.

Professional service corporations were not the only instance in which the IRS regretted the results produced by the Kintner Regulations. Once business began to pick up, the real estate industry figured out pretty quickly that state law limited partnerships that were classified as partnerships for tax purposes could provide private investors with both an investment product that was very similar to the pre-*Morrissey* REITs and significant tax benefits in the form of accelerated depreciation deductions fueled by leverage.¹⁷⁴

The IRS, seeing something it did not like, attempted to classify these early real estate limited partnerships as corporations for tax purposes, which would have ended the investor-level tax benefits. This time, it was the Tax Court that delivered the IRS its black eye, issuing its opinion in *Larson*¹⁷⁵ that a state law limited partnership that did not exhibit a preponderance of the corporate factors had to be classified as a partnership for tax purposes under the Kintner Regulations.

Just as it did after the decision in *Kintner*, the IRS responded to the decision in *Larson* by issuing proposed amendments to the Kintner Regulations that would have classified real estate limited partnerships as corporations for tax purposes. This strategy lasted all of two days,

after which the proposed amendments were withdrawn without comment. Although the official reason for the abrupt withdrawal has never been made public, the unofficial view is that the Department of Housing and Urban Development (“HUD”) arranged for the scuttling of the proposed regulations because the regulations would have destroyed HUD's low income housing program, which was for the most part carried on through privately owned limited partnerships.¹⁷⁶

This brings us to the last chapter in the story: the growth of the state law limited liability company (LLC). Although these entities are now ubiquitous throughout the American business landscape, they were at one time exotic. Surprisingly enough for something that was considered exotic, the LLC originated in Wyoming, in 1977.¹⁷⁷ The Wyoming LLC statute was set up in a way that allowed the entity to be taxed as either a corporation or a partnership under the Kintner Regulations.

For whatever reason, over the years following *Kintner*, the IRS did not amend the one thing it should have rewritten *in toto*: its playbook for dealing with developments in the world of unincorporated business entities. As evidence of that nonamendment, the IRS responded to the developments in Wyoming by proposing amendments to the Kintner Regulations that would have classified state law LLCs as corporations if no member possessed unlimited liability for the obligations of the entity. Because this approach applied only to state law LLCs and not to other entities such as state law trusts, limited partnerships, or joint stock companies, those latter entities could continue to structure their way into and out of corporate status at will. These amendments were withdrawn in 1983, and LLCs received little attention until the IRS issued Rev. Rul. 88-76,¹⁷⁸ in which it ruled that a Wyoming LLC could be taxed as either a corporation or a partnership under the Kintner Regulations.

By 1995, the IRS had been pushing the corporate resemblance test in one form or another for over seven decades with little, if any, positive tax policy results to show for it. This ought not be surprising, as the corporate resemblance test was devoid of intellectual underpinnings and was inconsistent with the policy objectives underlying the corporate tax itself. In any event, the effort to enforce a fundamentally flawed regulatory approach produced a seemingly endless stream of court cases involving untold costs for both the IRS and taxpayers; triggered tremendous criticism from both the tax bar and the courts; and damaged the image and reputation of Treasury and the IRS, which flip-flopped and reversed course on multiple issues, drew an apparent rebuke from another executive branch agency and lost high-profile cases after attempting

to rewrite the regulations in rifle-shot fashion. Thankfully, after the corporate resemblance test had been thoroughly discredited as a proper means to define the scope of the corporate tax, the test was discarded in 1997 in favor of the current check-the-box regime,¹⁷⁹ which, except in the case of a limited category of entities that are classified as *per se* corporations, allows all other entities to choose their entity classification simply by checking a box on a form. Although the check-the-box regulations were promulgated six decades too late for the REIT industry, we're quite sure that the late Senator Chandler would approve of the final result.

3. The Immediate Fallout from *Morrissey*: The Revenue Act of 1936

Because most REITs and RICs were operating in Massachusetts Trust form in the early 20th century, and because *Morrissey* applied equally to all Massachusetts Trusts regardless of their asset classes, the effect of *Morrissey* was to subject all REITs and RICs to the corporate tax.

By the time *Morrissey* was decided in 1935, the Great Depression was in full swing, and the losses in the real estate sector were staggering.¹⁸⁰ Many real estate companies likely felt that they had incurred enough tax losses to last for the foreseeable future and that real estate values were unlikely to recover any time soon. Although it is not entirely clear, it seems likely that the *Morrissey* decision had little immediate practical impact on the REIT sector.¹⁸¹

Although the RIC industry sustained heavy losses during the 1929 stock market crash, the losses were spread unevenly and many RICs were still earning significant income from interest and dividends. Other RICs were able to raise new money after the 1929 crash and were making new loans and investments through the 1930s. For RICs, the outcome in *Morrissey* was potentially devastating, as the imposition of two levels of tax would dilute investment returns to the point at which investors would be better off purchasing individual securities directly rather than through RICs.

The *Morrissey* decision put Congress in a difficult position. Congress had punted on the definition of "corporation," and the result was now a potential disaster for a very important sector of the U.S. economy. The powerful investment management industry was up in arms over the potential destruction of their business model, which was still important for the formation of new capital. More importantly, the savings of small investors were now at risk of being eroded through the imposition of the corporate tax on the RICs in which they had invested. Worse yet, if *Morrissey* were allowed to stand, small investors, who had been able to spread risk and achieve diversification only

by investing through RICs, would be forced to acquire shares directly in the market, if at all. In other words, if the *Morrissey* decision were allowed to stand, small individual investors would be incentivized to eschew professionally managed diversified collective investment vehicles in favor of nondiversified direct investment in individual securities.

It did not take long for Congress to act. The *Morrissey* decision was issued in December of 1935, and by the fall of 1936, the *Morrissey* decision had been legislatively reversed with respect to RICs. The Revenue Act of 1936 (the "1936 RIC Legislation"), among other things, provided RICs the ability to deduct distributions paid to their owners, meaning that RICs would not be subject to tax on income distributed to owners.¹⁸²

There are several interesting aspects of the 1936 RIC Legislation that are relevant to the modern policy discussion on REITs.

First, when Congress defined the types of entities that could qualify for taxation as a RIC, it adopted what amounts to an *ad hoc* description of the pre-*Morrissey* RIC operating model.¹⁸³ This indicates that Congress was not enacting a new regime but simply confirming the institution's view that, given the policy objectives underlying the corporate tax, RICs are not the type of entity that should ever have been subject to the corporate tax. This view is supported by the Senate testimony of Arthur Kent, the Bureau's Acting Chief Counsel, who, in response to Senator Couzen's question regarding why investment trusts should not be subject to the corporate tax, replied:

I am not certain that Congress actually intended to include them [i.e., investment trusts], or that this situation was considered when the association definition was written into the Act. As a matter of fact, until comparatively recently they made their returns as trusts and were taxed upon that basis, and as a result of these recent court decisions [i.e., *Morrissey*, *Swanson v. Commissioner*, *Helvering v. Combs*, and *Helvering v. Coleman-Gilbert Assoc.*¹⁸⁴], they have been swept into the association group and are now being taxed as corporations.¹⁸⁵

Second, the 1936 RIC Legislation contained two provisions indicating a congressional aversion to imposing the corporate tax on income and gains from collective investment. In particular, the 1936 RIC Legislation allowed a RIC to deduct the amount of all distributions paid to shareholders, which meant that RICs were exempt from the corporate tax not only on dividend income but also on interest and capital gains as well.¹⁸⁶ Reinforcing this theme, the 1936 RIC Legislation contained an asset

diversification test designed to protect investors. This test prohibited a RIC from investing more than five percent of its assets in the securities of a single issuer.¹⁸⁷

Third, when it enacted the 1936 RIC Legislation, Congress faced an interesting choice. On the one hand, it could rewrite the rules on trust taxation in a way that ensured RICs would continue to retain their status as trusts for tax purposes. While intellectually satisfying and consistent with the policy objectives underlying the corporate tax, the process to implement this approach would likely have been laborious and lengthy, and it is entirely possible that the enabling legislation might not have been available for inclusion in the Revenue Act of 1936. On the other hand, Congress could simply grant RICs the ability to deduct distributions made to its owners. From an intellectual perspective, this approach was unsatisfying because it gave the impression that RICs should have been subject to tax as corporations in the first instance, a position that was inconsistent with both the policy objectives underlying the corporate tax and the Senate testimony of Acting Chief Counsel Kent. Still, providing RICs with a deduction for dividends paid to its owners seemingly required less significant legislative drafting and minimized the risk that the RIC legislation would not be available for inclusion in the Revenue Act of 1936. Congress chose the latter approach, which, as discussed in Part IV.B below, has had a tremendous impact on how we think about REITs.

Finally, and perhaps most importantly, when it enacted the Revenue Act of 1936, Congress included two new rules that emphasize that the policy objectives underlying the corporate tax remained top-of-mind in 1936 and illustrate how the regulatory view of the corporate tax and the capital lock-in view of the corporate tax can co-exist with one another.

The first rule prohibited RICs from owning more than 10 percent of the stock or securities of any one corporation.¹⁸⁸ This rule was designed to prevent RICs from being used by financiers to engage in monopolistic behavior. This concern makes complete sense in light of both the history that led to the adoption of the corporate tax as well as the corporate tax provisions in effect as of 1936.¹⁸⁹ This provision also supports the view that the regulatory view of the corporate tax was alive through the Great Depression.¹⁹⁰

The second rule, which illustrates the vitality of the capital lock-in theory, was contained in Section 14(b) of the Revenue Act of 1936 and was designed to discourage corporations from retaining their earnings. The rule, referred to as the undistributed profits tax, imposed an additional tax at graduated rates on the undistributed profits of every corporation. The undistributed profits tax rate began at seven percent for corporations that distributed

at least 90 percent of their profits and ratcheted up to 27 percent for corporations that distributed 40 percent or less of their profits.¹⁹¹ Although it may appear regulatory at first blush, this rule was actually designed to prevent corporations from “hoarding cash” in the form of retained earnings.¹⁹² The idea was that economic conditions might improve if corporations were incentivized to distribute their earnings to shareholders. Although the idea that corporate cash hoarding contributed to the Great Depression was ultimately discredited, Professor Bank’s work on the capital lock-in theory illustrates how the undistributed profits tax was one of the many battles waged between government and corporate managers over the control of retained earnings.

In sum, when viewed in the context of the modern debate on REITs, the 1936 RIC Legislation represents a remarkable piece of the tax policy picture. First, the structure of the statute, the rapidity with which the statute was adopted and the testimony given in support of the statute all support the view that the 1936 RIC Legislation was a congressional rebuke of the corporate resemblance test advanced by Treasury and upheld by *Morrissey*, as it applied to collective investment vehicles such as RICs. Second, the fact that the 1936 RIC Legislation exempted all types of RIC-level investment income from the corporate tax, rather than simply dividends received from other corporations, when combined with the investor protection objectives of the legislation, indicate a congressional policy in favor of collective investment.¹⁹³ Simply put, the 1936 RIC Legislation provides clear evidence that Congress favored the act of collective investment by small investors and did not believe it appropriate to punish that act through the imposition of the corporate tax. Third, the 10-percent asset concentration limits imposed on RICs, combined with the undistributed profits tax imposed on regular corporations, indicate that Congress in 1936 was just as concerned with corporate retained earnings as it was in 1909.

B. 1960 and the Revival of the REIT

As discussed above, many real estate developers and sponsors were wiped out by the Great Depression, and their collective views as of 1935 on the potential for American real estate development were so bleak that they apparently saw no need to follow the RIC industry into Congress for relief from the *Morrissey* decision. That lack of optimism would leave the real estate industry scrambling for capital once the allies won World War II and the troops came home and got back to work.¹⁹⁴

In the early years after the war, real estate developers and

sponsors raised money for projects through syndicated limited partnerships.¹⁹⁵ In a typical structure, a sponsor would own the general partner interest in the partnership and the partnership would issue limited partner interests to investors in exchange for cash that the partnership would use to fund its real estate business. These entities provided investors with the yields they were seeking as well as a number of tax benefits owing to the tax law's treatment of depreciation deductions attributable to leverage.

Yield-producing assets such as rental real estate typically must be held in passthrough form, otherwise the corporate-level tax would dilute the investment's yield to the point where the investment would no longer be attractive at the price offered by the developer or sponsor. Limited partnerships could be classified as either partnerships or corporations under the corporate resemblance test.¹⁹⁶ As a threshold matter, the entity technically did not possess "limited liability" within the meaning of the corporate resemblance test because one partner—the general partner—bore personal liability for all of the partnership's debts. Thus, in order to avoid corporate classification, the partnership needed to lack at least two of the remaining corporate characteristics. For that reason, most limited-partner interests were nontransferable, and the partnership was required to liquidate on a date certain in the not-too-distant future.

With passthrough taxation secured, real estate developers and sponsors were able to raise significant amounts of capital through real estate limited partnerships. That being said, capital—even private sector capital—became scarce during the 1950s, which is not surprising given the number of massive capital-intensive projects being undertaken at the time, including the rebuilding of Europe and Japan, the Korean War, the Cold War arms build-up, and the build-out of American infrastructure (*e.g.*, the interstate highway system and the air transit system).¹⁹⁷

When capital becomes scarce, the returns demanded by equity investors begin to rise. In the real estate sector, when equity investors demand more of a return, those demands result in lower property values and returns for developers and sponsors.

Thus, by the mid-1950s, two things were true. First, income-producing real estate investments were available only to private investors who had the financial means to either acquire their own real estate or participate in syndicated limited partnerships. Because C corporations could not hold real estate in a way that made economic sense for stockholders, small public investors were locked out of the rental real estate sector altogether. Second, the syndicated limited partnership capital market was not capable of providing real estate developers and sponsors

with the amount of capital that they needed.

This dynamic is what led the real estate industry to do what the RIC industry did in 1935: to ask Congress to reverse the Supreme Court's decision in *Morrissey* and allow the industry to raise funds from small public investors in a way that made economic sense for all parties. The industry asked Congress to revive the old REIT.

1. Reviving an Old Vehicle

When Congress decided to revive the REIT vehicle by enacting the 1960 REIT legislation, its stated policy objectives reflected the commercial events that led the real estate industry to seek the revival of the REIT. Thus, Congress indicated that it was acting to advance both populist and capital markets policies.

On the populism front, the legislative history of the 1960 REIT legislation bemoans the fact that private ownership of rental real estate was largely concentrated in the hands of wealthy investors who used the partnership form. Congress viewed the 1960 REIT legislation as leveling the playing field between the "wealthy" and the "mom and pops" of the world by providing the latter with a way to pool their money in order to acquire a diversified and professionally managed portfolio of real estate assets without being subject to two levels of taxation.¹⁹⁸ The notion that collective investment vehicles should be exempt from corporate-level tax is a common theme in our tax law. Indeed, it was the primary justification for the 1936 Act's exemption of mutual funds from the corporate tax,¹⁹⁹ on which the 1960 REIT legislation was based. On the capital-markets front, the legislative history cites the need of real estate promoters to better access the public capital markets in order to advance large commercial real estate projects.²⁰⁰

In thinking about whether REITs should have been subject to the corporate tax in the first place, it is interesting to note that the REIT created by the 1960 REIT legislation was a somewhat limited version of the 1930s-era REIT and a more or less *ad hoc* description of the mid-to-late 19th-century REIT.²⁰¹ The basic organizational requirements imposed on REITs at that time—*i.e.*, that a REIT must be organized in trust form, must be managed by its trustees, must be an entity that would otherwise be subject to tax as a corporation and must have at least 100 shareholders—more or less describe the pre-*Morrissey* Massachusetts real estate investment trust. The income test, asset test and distribution requirements were also a basic sketch of the manner in which REITs had operated since the 19th century. Viewed that way, the 1960 REIT legislation, similar to the 1936 RIC Legislation, revived an investment vehicle that, like the RICs of 1935,²⁰² operated in a way that did not implicate the policy objectives

underlying the corporate tax.

Although the 1960 REIT legislation was intended to create a useful vehicle for the collective investment in real estate, it was immediately apparent to real estate professionals that the REIT of 1960, while well suited for a 19th-century real estate operating model, was too limited for the mid-20th century. For example, under the 1960 REIT legislation, a REIT generally could not provide any services (even customary services), unless it hired an independent contractor to do so.²⁰³ TRSs did not yet exist, so the REIT had no ability, as REITs have today, to furnish services through a wholly owned subsidiary at the cost of a corporate tax on that subsidiary's income. Other restrictions, too, applied in 1960 that do not apply now,²⁰⁴ but those differences are less relevant to this article than the differences relating to tenant services.²⁰⁵ Many commentators writing shortly after the adoption of the 1960 REIT legislation noted that, if these limitations were not removed, many real estate sponsors would likely eschew the REIT vehicle in favor of syndicated limited partnerships, in a sense undercutting the very policies that led to the enactment of the legislation.²⁰⁶

As discussed below, the limitations of the 1960 REIT legislation, and the manner in which they undercut the policies underlying that legislation, led to the adoption of rules that enhanced the ability of a REIT to operate in a modern business climate while remaining true to its original objective of providing a vehicle for the collective investment in real estate assets.

2. Modernizing the REIT Vehicle

Under the 1960 REIT legislation, a REIT could not provide any services to its tenants—even customary services—unless it hired an independent contractor²⁰⁷ to do so, and even then, income attributable to the services would be qualifying REIT income only if both (i) the services were customary, and (ii) the charge for the services were not separately stated and instead were bundled into the monthly rental amount.²⁰⁸ In other words, income attributable to the provision of services would be qualifying REIT income only if all of the following requirements were satisfied: (i) the service was customary; (ii) the service was furnished by an independent contractor; and (iii) the charge for the service was built into the monthly rent received by the REIT rather than being separately stated. All other income received by a REIT for services—including any customary services that either bore a separate charge or were furnished the REIT or its affiliates—was nonqualifying income.

The practical effect of these rules was that substantially all income for services had to be separately stated and

received and retained by the independent contractor.²⁰⁹ In other words, if some tenants wanted specialized services, the REIT would have to find an independent contractor to provide those services and then arrange for the independent contractor to bill the tenant separately for those services. This meant REITs had very limited ability to share economically in any income attributable to the provisions of services, but also were required to go through the cumbersome process of finding and negotiating with third parties to provide those services, a task that could not be done quickly or easily every time the market created tenant demand for a new service. REITs simply could not compete in the marketplace with these kinds of restrictions, which undercut the policy objectives of the 1960 REIT legislation.²¹⁰

The first major modernizing amendment to the tenant-services provisions of Code Sec. 856 came in 1976, when Congress allowed REITs to treat as qualifying income *all* charges for customary services, whether bundled in the monthly rent or separately stated.²¹¹ Although, under the 1976 amendments, the services still had to be furnished by an independent contractor rather than the REIT itself,²¹² a REIT at least could share economically in the income from these services without having to bundle the charge into the monthly rent. Under the 1976 amendments, a REIT that hired an independent contractor to provide, for example, customary trash-collection or pool-cleaning services could separately bill the REIT's tenants for those services (which presumably would generally reflect a mark-up over the actual fees paid by the REIT to the contractor for the services).

As noted above, though, the 1976 amendments were still overly restrictive by requiring even customary services to be provided by an independent contractor. Congress finally addressed this problem in 1986 by amending Code Sec. 856 to allow REITs themselves to furnish (and treat as qualifying the income from) customary services.²¹³ After 1986, independent contractors would be needed only for noncustomary services.

Although the 1986 amendments were helpful to the REIT industry, the inability to control (and meaningfully share economically in) the provision of noncustomary tenant services still put REITs at a significant competitive disadvantage. Thus, in 1999, in what may have been the single most important amendment to the REIT rules since their original enactment in 1960, Congress created the TRS and, in doing so, allowed REITs to furnish almost any tenant services they wished,²¹⁴ as long as, in the case of noncustomary services, they did so through a tax-paying corporate subsidiary. With the creation of the TRS, Congress finally struck a reasonable balance between the original conception of the REIT as a real estate rental

vehicle (rather than a service provider) and the need of REITs to compete with other real estate rental vehicles in the real world.

V. Challenging the Premise That REITs Should Be Subject to the Corporate Tax

The Code classifies REITs as corporations for tax purposes. In fact, an entity cannot elect REIT status unless it is already classified as a corporation for tax purposes.

The fact that the Code treats REITs as corporations for tax purposes is nothing more than a rule. More precisely, it is nothing more than a rule which claims as its foundation another rule—the corporate resemblance test—which itself resulted from the historical development of both the corporate tax and the view of the corporation as a natural entity under the law.

More than a century ago, Justice Holmes urged the members of our profession to practice with a number of key principles in mind, two of which are particularly relevant here. First, Justice Holmes reminded us that history in and of itself does not possess normative power. In other words, history, standing alone, can only tell us what happened and cannot tell us whether what happened was right. Second, Justice Holmes admonished us to understand the origins and purposes of a rule before we rely on it or apply it in practice. To paraphrase a passage from his *Path of the Law* speech: It is not good enough for us to rely on tradition to justify our legal conclusions; and one of the worst mistakes we can make as lawyers is to blindly accept and apply a rule which rests on legal foundations that no longer exist.²¹⁵

In the context of the current debate on the proper taxation of REITs, Justice Holmes reminds us that the fact that a rule exists and has existed for a long time cannot, standing alone, tell us whether the rule reaches the correct result or rests on good authority. In this case, the entire debate on the proper taxation of REITs rests on the premise that REITs should be subject to the corporate tax in the first instance. Proponents of that position do not offer any normative justification for that premise and instead rest the entire debate on a statutory rule that, as Justice Holmes would tell us, has no normative power, might not reach the correct result and might not be based on good authority.

In this Part V, we analyze the question of REIT taxation in light of the advice offered by Justice Holmes. First, we examine the origins of the false premise that REITs should be subject to the corporate tax in the first instance—the

corporate resemblance test—and discuss how that false premise became entrenched in our collective thinking. We conclude that, as a matter of logic, this premise can no longer be founded upon the corporate resemblance test and, if the premise is to continue, it must find another foundation. This brings us to the next part of the analysis, where we examine whether REITs should have been subject to the corporate tax in the first instance, taking into account the policy objectives underlying the corporate tax. After concluding that REITs should not have been subject to the corporate tax in the first instance, we analyze the modern developments in the REIT space and conclude that these developments do not undercut the view that REITs should not be subject to the corporate tax. Our ultimate conclusion is that, if we are to determine the scope of the corporate tax in light of its underlying policy objectives, REITs should never have been, and should not be, subject to that tax.

A. The Corporate Resemblance Test as a Wellspring of an Incorrect Premise

The key events that helped create the false premise that REITs should be subject to the corporate tax in the first instance can be stated quite simply: The congressional punt on the definition of “corporation” allowed the Bureau, and later the IRS, to attempt to drag into the corporate tax base a number of unincorporated entities that did not retain their earnings. This process began in earnest with the Supreme Court’s decision in *Hecht*, which emboldened the government and spawned a series of new and more aggressive Treasury regulations, which spawned the corporate resemblance test described in *Morrissey*, which spawned the Kintner Regulations. The Kintner Regulations were widely viewed as poorly conceived and, after nearly a half century of pain inflicted on both taxpayers and the government, the same government that created the Kintner Regulations discarded them.

At this point, the Kintner Regulations and the corporate resemblance test are usually mentioned only by the most seasoned members of our profession as evidence of how long they have been practicing. Few of those people, if any, ever mention the *Morrissey* decision. It is almost as if an entire profession agreed to collectively forget an unfortunate foray into ridiculousness. In that sense, the *Hecht-Morrissey-Kintner* line of authorities, the Kintner Regulations and the entire concept of the corporate resemblance test would seem to be the tax profession’s equivalent of the big hair and bell bottom jeans fads of the 1970s.

At a deeper level, however, those authorities still influence our collective thinking on the topic of REIT taxation.

Intellectually speaking, our profession finds itself in a rather bizarre situation. Despite the fact that the entire line of authority underlying the premise that REITs should be subject to the corporate tax in the first instance has been both discredited intellectually and discarded by the government, our profession continues to rely on that premise, and indirectly on those discredited and discarded authorities, as the intellectual starting point for a tax policy debate that has the potential to pose an existential threat to an industry that is critical to the U.S. economy. If we continue down this path, we will certainly run afoul of Justice Holmes' admonition against allowing a rule to persist out of "blind imitation of the past."

Fortunately, tax lawyers as a group are not known for intellectual blindness. To the contrary, we pride ourselves on our reputation as the deep thinkers of the bar, a reputation that was earned through the efforts of those who came before us. It is this reputation for deep thinking and the related opportunities for intellectual challenge that attracted many of us to the profession in the first place. Tax lawyers by nature enjoy, and in fact thrive on, intellectual puzzles. It is in that spirit that we ask two questions: How did we get sucked into relying on discredited and discarded authorities to frame a tax policy debate that may affect the future of a critical industry, and how do we get ourselves back on track?

Although the true answer to the first question is ultimately unknowable, based on conversations with our colleagues in the profession, we think the answer lies partly in how Congress handled the 1936 RIC Legislation, partly in how the Treasury Department reacted to REITs during the period leading up to and following the enactment of the 1960 REIT legislation, and partly in how we as tax lawyers have been trained to think about the Code and tax policy issues.

Focusing first on Congress' handling of the 1936 RIC Legislation, it seems that part of the reason why so many people are willing to accept without question the general rule that REITs should be subject to the corporate tax in the first instance is that REITs look a lot like RICs and that, because the 1936 RIC Legislation was enacted so quickly after *Morrissey* was decided, RICs were never actually subjected to the corporate tax. In other words, in a world where we are rarely required to research a Code provision beyond the 1939 Code at the earliest, it is easy to accept both the proposition that RICs are "naturally" exempt from the corporate tax and the negative inference produced by that proposition—that REITs should "naturally" be subject to the corporate tax. We think this outcome is unfortunate because, by enacting the 1936 RIC Legislation, Congress did not so much create a

"new regime" for RICs as it partially overruled *Morrissey* and confirmed that, as applied to collective investment vehicles such as RICs, the corporate resemblance test and *Morrissey* reached the wrong result. By overruling *Morrissey* with respect to RICs but leaving REITs within the corporate tax system, Congress created a legal distinction between two vehicles that ought never have been treated differently, and this distinction has colored our collective thinking ever since.

The Treasury Department made its own unique contributions to this state of affairs. The most enlightening example of Treasury's hostility to REITs comes from the Treasury's reaction to REIT legislation proposed in 1956. The 1956 proposal, which was substantially identical to the 1960 REIT legislation, was vetoed by President Eisenhower, apparently at the behest of his Treasury Secretary, who viewed the legislation as an inappropriate narrowing of the corporate tax.²¹⁶ According to prominent authors in the REIT space, "[w]hen the then Secretary of the Treasury first viewed the proposed REIT legislation, he is reported to have said: 'If they [REITs] can do it, why can't GM—GM can be said to be only in the business of investing in automobiles and passing on the income to its shareholders.'"²¹⁷

If the Treasury Secretary was trying to create the starkest possible example of the intellectual disconnect between his department's view on the proper taxation of REITs and his department's view on the policy objectives underlying the corporate tax itself, he could not have picked a better example than the comparison between REITs and GM. In the quote, the Treasury Secretary suggests that GM would suffer an unfair result if REITs were exempted from the corporate tax while other C corporations were not. In framing his department's objections to the 1956 REIT Proposal in that way, the Treasury Secretary simultaneously highlighted the pernicious effect of the negative inference created by the 1936 RIC Legislation and provided an example of why the policy objectives underlying the corporate tax were well founded.

First, the Treasury Secretary's quote obviously assumes without any further thought that REITs are different from RICs, and that REITs should be subject to the corporate tax while RICs should not. It would not surprise us if that assumption is attributable to the legacy of *Morrissey* and the unfortunate negative inference created by the 1936 RIC Legislation.

Second, and perhaps more importantly, the quote, by focusing on GM, unwittingly demonstrates why the original policies underlying the corporate tax, whichever is adopted, were well founded and why REITs do not implicate those policies. GM's stature in this country after

World War II cannot be overstated. At that time, GM was in its heyday, having just earned a massive amount of money and developed tremendous connections inside the government following its efforts to keep our military equipped during the war. In an age when American industry was coming into its own, GM was the largest industrial producer of the time.²¹⁸

While GM produced great products and made enormous contributions to our country, GM's level of influence in society and its operating style from the 1930s through the 1960s serve to validate the policy objectives underlying the corporate tax. For example, insofar as the corporate tax exists to curb the power of corporate managers or reduce retained earnings, it is striking to note that GM's wealth and earning power provided its managers so much influence over our government that Charles Erwin Wilson, then CEO of GM, was appointed Secretary of Defense to President Eisenhower.²¹⁹ Second, insofar as the corporate tax was designed to limit the ability of corporate managers to use retained earnings to pursue monopolistic and other unfair trade practices, it is downright astounding that the Treasury Secretary's quote came just seven years after GM's criminal conviction in the National City Lines antitrust conspiracy²²⁰ and only five years after a federal appeals court upheld that conviction.²²¹

The idea that the Secretary of the Treasury would use GM as an example of the type of entity that would be treated unfairly if REITs were exempted from the corporate tax illustrates three key points. First, Treasury failed to use the 20-year period following the *Morrissey* decision to reacquaint itself with the policy objectives underlying the corporate tax. Second, as the use of GM in the example indicates, those objectives were as relevant in 1956 as they were in 1909. Third, because Treasury had lost touch with the policy objectives underlying the corporate tax, it never grasped the manner in which REITs could help advance those policy objectives, as described in Part VI.B below.

This brings us to the topic of how we as lawyers are trained to think. When we think about an issue or interpret a statute, we often think in terms of general rules and their narrowly construed exceptions, and we seemingly allow our judgment to be influenced by intellectual presumptions, some of which might not be acknowledged consciously. We think that one or both of these mental processes may have played a role in our collective reliance on dead authorities to support the premise of a modern tax policy debate.

Turning first to general rules and their narrowly construed exceptions, the statutory structure governing REITs would certainly seem to create both a "general rule" that REITs should be subject to the corporate tax in the first

instance and a corresponding "narrowly construed exception" for entities that satisfy the requirements of Code Secs. 856 through 859. Although this statutory structure is certainly part of the reason why so many people are willing to base a tax policy debate on the premise that REITs should be subject to the corporate tax in the first instance, the statutory structure alone cannot fully explain this premise for one simple reason: RICs and REITs are governed by the same statutory structure, and yet most of us seem to view RICs as entities that should "naturally" fall outside the corporate tax. If we were truly basing our

Why, then, would anybody choose a REIT over a nontaxpaying partnership? The answer is largely explained by the ability of a REIT (but not a partnership) to distribute its income in the form of corporate dividends.

premises on the manner in which statutory structure creates general rules and narrowly construed exceptions, then our collective underlying views on RICs and REITs could not both be correct.

This brings us to the topic of our use of intellectual presumptions. Whether we acknowledge it or not, many of us often think our way through a tax policy issue by setting up a presumption—a "base case," if you will—and then testing whether or not the presumption (or base case) should apply to a given set of facts. We use these intellectual presumptions or base cases to create intellectual starting points, which ultimately develop into our views on tax policy. The events outlined above, when combined with the statutory structure of Subchapter M, created in our minds a presumption of nontaxation for RICs and a presumption of taxation for REITs.

These two presumptions, taken together, have the effect of skewing the debate against the REIT industry in a truly insidious way. That is because, as lawyers, once we have formed a presumption in our minds, we are trained to impose the burden of proof on the party seeking to overcome the presumption. Thus, many of the participants in the current tax policy debate on the proper taxation of REITs seem to be starting from the positions that the presumption of nontaxation for RICs is virtually insurmountable but that the REIT industry bears a heavy burden of proving to the rest of

the world why it should not be subject to the corporate tax. Given the history described above and the policy objectives underlying the corporate tax, this starting point is inappropriate.

In thinking about how harmful these two presumptions have been to the REIT industry, it is important to note that they are not a phenomenon of the current policy debate, nor are they applied solely by the REIT critics. To the contrary, the notions of presumptive nontaxation for RICs and presumptive taxation for REITs seem to run throughout our entire profession. We have been unable to locate in post-1960 tax literature any debate on the question of whether RICs should be subject to the corporate tax, even in the obvious case where a RIC holds indebtedness of a C corporation and the C corporation receives a deduction for interest paid to the RIC, which is an arrangement that allows income to move from a customer of a C corporation to a shareholder of a RIC without any imposition of corporate tax. In addition, we have been unable to locate any post-1960 tax literature arguing that, based on first principles underlying the corporate tax, REITs should not have been subject to that tax in the first instance.²²²

At this point in the history of our tax system, the view that a RIC should be excluded from the corporate tax base in the first instance seems practically sacrosanct and the view that a REIT should be included in the corporate tax base in the first instance seems beyond reproach. Although we agree with the first view as a matter of corporate tax policy, we think that, in the minds of most people, those two views derive not from an in-depth analysis of first principles but from a combination of the timing of the 1936 RIC legislation, the fact that REITs were not given similar relief in 1936, the Treasury Department's treatment of the REIT industry in the early years, and the way in which these events have influenced our collective thinking in ways that we might not fully appreciate. One has to seriously consider whether the recent debate on the proper taxation of REITs would have been conducted with the same level of vitriol, or indeed if it would have been conducted at all, had REITs been included in the Revenue Act of 1936 as a collective investment vehicle that ought never have been subject to the corporate tax.

Turning now to our second question—how do we get ourselves back on track?—we think it is time to correct the record. If we are to have a debate on the proper taxation of REITs, we ought not base that debate on a line of authorities comprising a doctrine—the corporate resemblance test—that has been discredited intellectually (for good reason) and discarded by the government (also for good reason). The corporate resemblance test and every authority that at any time helped to provide validity to

that test—including the Kintner Regulations, *Hecht* and *Morrissey*—died for good reasons. Those authorities should stay dead, and we should stop relying on them to frame our current debate on the proper taxation of REITs.

In order to move forward with a policy debate that is both intellectually honest and productive, we need to base the debate on a valid premise. In order to figure out what that premise ought to be, we think we should return to first principles and ask two simple questions: Based on the policy objectives underlying the corporate tax, should REITs have been subject to that tax in the first instance? If not, do recent developments change the conclusion? Parts V.B and V.C address those questions.

B. Starting from the Right Place: REITs Should Never Have Been Subject to the Corporate Tax

We think that one of the best ways to figure out what premise should underlie a policy debate on the proper taxation of REITs is to analyze how Congress would have treated REITs in 1909 had they thought about the issue of REIT classification in the first place.²²³ As discussed below, we believe that, because REITs did not implicate the policy objectives underlying the corporate tax and indeed helped further those policy objectives, Congress would not have thought that REITs were subject to that tax in the first instance. We think the modern debate ought to start from that premise.

Given the state of the record, it is not possible to state with certainty exactly how each and every REIT operated between the early 19th century and the mid-1930s; the available technology and media resources simply could not accommodate a contemporaneous account of all aspects of business life during that time. That said, we do have significant evidence, in the form of court opinions and secondary authorities written either contemporaneously or shortly after that period, to give us a solid enough foundation to conclude that should not have been subject to the corporate tax in the first instance.²²⁴

First, we know that REITs were vehicles for the collective investment in real estate development and ownership. REITs were created by sponsors in order to develop and sell, develop and rent or buy and rent different types of commercial real estate properties. This is important because our tax system has historically favored vehicles that existed for the collective investment in income producing assets, as evidenced by the rapid enactment of the 1936 RIC Legislation.

We also know that REITs raised money from a wide variety of investors and that one of the benefits of REIT equity was periodic distributions of cash flow. In other words, we know

that REITs were designed to pursue real estate ventures in a way that produced a cash flowing security for investors, which means that REITs did not retain their earnings.

Third, insofar as one subscribes to the regulatory view of the corporate tax, we know that real estate investment did not have the same tendency toward monopoly that plagued other businesses, such as the railroads, oil production and commodities. In fact, competition in the real estate space was the historical norm, with the company towns of the late 19th and early 20th centuries being exceptions to the rule.²²⁵ This makes sense given the differences between developing real estate for rental or sale, on the one hand, and manufacturing and selling goods or providing services, on the other. The latter can tend toward monopoly in a way that the former cannot.²²⁶

These three features of the early REITs—their use as collective investment vehicles, their propensity to distribute earnings and the lack of monopoly risk—all show that the REITs of the 19th and early 20th centuries simply did not implicate any of the policy objectives underlying the corporate tax. Instead, similar to RICs, REITs operated in a way that was consistent with nontaxation. Neither entity should have ever been subject to the corporate tax.

Finally, REITs actually helped advance the policy objectives underlying the corporate tax. That is, by holding real estate and charging tenants rent, a REIT that leased space to corporate tenants could prevent the accumulation of earnings in the same way as a lender charges interest for the use of money. The fact that the original corporate tax allowed a deduction for interest payments, which has been justified as reducing the accumulation of retained earnings by corporations, combined with the swift legislative reversal of *Morrissey* as it relates to RICs, all support the conclusion that REITs should not have been subject to the corporate tax.

C. Recent Developments Do Not Change the Conclusion That REITs Should Not Be Subject to the Corporate Tax

False premises, intellectual presumptions and powerful words seem to have created a visceral aversion to REITs among certain members of the media, academic, political and practitioner communities—we call them the REIT critics, for lack of a better term—and this group seems to view REITs' use of TRS structures, the development of nontraditional REIT assets and the movement of assets from C corporation form to REIT form, whether by way of C-to-REIT conversion or REIT spin-off, as a drain on the fisc and an inappropriate extension or use of the REIT vehicle.

Professor Borden has addressed the first concern, concluding that C-to-REIT conversions and REIT spin-offs do not affect overall tax receipts nearly to the extent that some of the REIT critics seem to believe. Most C corporations have relatively low dividend payout ratios—on average, just 25 percent—while REITs must distribute 90 percent of their taxable income, and in practice, often distribute more than 100 percent.²²⁷ Consequently, because REITs do not offer deferral to their shareholders (income is distributed rather than sheltered in corporate solution), increased revenue from increased taxes on distributions to shareholders mitigates entity-level tax reductions.²²⁸ Depending on various assumptions regarding dividend payout ratios and effective tax rates on shareholders, the overall effect may be as low as seven percent. Additionally, if a C corporation converts to or spins off a REIT, it must make a “purging” distribution of the REIT’s share of the C corporation’s historical earnings and profits.²²⁹ These purging distributions are often very significant,²³⁰ and the up-front tax on them further reduces any aggregate tax advantages of REIT spinoffs.²³¹

Professor Borden’s analysis validates what many REIT practitioners intuited but had not undertaken the effort to prove out: because the revenue effects of the entity-level tax benefits enjoyed by REITs are offset by higher taxes paid by REIT shareholders, C-to-REIT conversions and REIT spin-offs may not materially reduce overall tax revenues and, in certain instances, may actually increase tax revenues.

This Part addresses the second concern of the REIT critics—that the development of TRS structures, nontraditional REITs, C-to-REIT conversions and REIT spin-offs represent an inappropriate use of the REIT vehicle. In our view, these types of developments should only be viewed as problematic from a tax policy perspective if one of the following is true: (i) REITs are failing to advance the populist and capital markets policy objectives underlying the 1960 REIT legislation; (ii) REITs are acting in a way that would run afoul of the policy objectives underlying the corporate tax by facilitating the accumulation of retained earnings; or (iii) REITs are hindering some other, more important policy goal of Congress. As discussed below, the modern developments in the REIT space do not produce the first two outcomes, and we have yet to encounter an argument that REITs are producing the third. Therefore, the modern developments do not alter our conclusion that REITs should not be subject to the corporate tax in the first instance.

1. The Use of TRS Entities and the “Operating REIT” Debate

The debate around the use of TRS entities essentially focuses on two topics: (i) a REIT’s ability to own 100 percent

of the stock of a TRS; and (ii) the ability of that TRS to earn income that does not qualify under the REIT income tests and to provide noncustomary services to tenants of the REIT.²³²

(a) TRSs That Earn Non-REIT Income. REITs have been able to own non-REIT operating companies in one form or another since the 1960 REIT legislation. At that time, the 10-percent asset test limited a REIT's ability to own more than 10 percent of the voting power of a C corporation but did not limit the ownership of low voting stock that accounted for more than 10 percent of the value of the corporation.²³³ Thus, subject to the 75-percent and five-percent asset tests, a REIT was permitted to own low voting stock in a C corporation that represented substantially all of the economics of the corporation. Such a C corporation could engage in any activity other than providing services to tenants of the REIT. Many REITs used this structure to engage in non-REIT activities prior to the adoption of the TRS Legislation in 1999. After that, REITs generally pursued all non-REIT qualifying activities through the TRS structure.

It is hard to see why a REIT's ownership of a TRS that earns non-REIT income is problematic. A REIT that earns non-REIT income through a C corporation subsidiary is acting exactly like a RIC. To the extent the REIT is behaving exactly like a RIC, and non-REIT income is being taxed at the TRS level, this aspect of the debate does not present a tax policy issue that is unique to REITs as compared to RICs. Given that none of the REIT critics are suggesting that RICs should be prevented from owning C corporations that earn non-RIC income (indeed, that is the *raison d'être* for every equity-focused RIC), as well as the fact that TRSs pay corporate-level tax on their income,²³⁴ we view this aspect of the operating REIT debate as a nonissue.

(b) TRSs That Provide Tenant Services. When it comes to REIT critics' concerns over the use of TRS structures, a significant focus seems to be on whether a REIT should be allowed to provide noncustomary tenant services through a wholly owned TRS. In our view, because it is theoretically possible for a REIT to rely on independent contractors to perform all tenant services, the real question is whether a REIT should be forced to rely on independent contractors to provide tenant services in order to maintain REIT status.

Property owners compete with one another for tenants and therefore must either respond to tenants' demands for services or risk losing their tenants to other property owners who are willing to satisfy those demands. If the shareholders of a REIT are best served by investing in properties that require tenant services in order to compete in the market place, then eliminating TRSs would

present those shareholders with a choice among three undesirable alternatives: (i) allow their entity to earn the profits associated with the services at the cost of relinquishing its REIT status, (ii) maintain REIT status at the cost of retaining an independent contractor who will necessarily capture those profits and who might not provide the same level of service that the REIT could provide on its own, or (iii) forgo investing in the types of properties that require noncustomary tenant services. If REIT investors were forced to make such a choice, the populist/capital markets policies underlying the 1960 REIT legislation would be frustrated without advancing in any way the policy objectives underlying the corporate tax.

Viewed from this perspective, the fact that REITs are allowed to use TRSs to provide tenant services helps REITs carry out the policy objectives underlying the 1960 REIT legislation without running afoul of the policy objectives underlying the corporate tax. In fact, since most real property in this country is owned in either partnership form or REIT form, the use of the REIT/TRS structure may actually result in more corporate tax being paid than the likely alternatives. Given the limits on the size of TRSs,²³⁵ which in turn limits a TRS's retained earnings, this does not pose a corporate tax policy problem.

(c) Concluding Thoughts on the Use of TRSs. Although the *unlimited* and *unchecked* use of TRSs could present tax policy problems, the key limitations on a REIT's ability to deploy TRS entities—*i.e.*, the 25-percent (beginning in 2018, 20-percent) size limit on TRSs and other non-real estate assets, the fact that dividends and non-real-estate interest paid by a TRS to a REIT do not qualify for the 75-percent income test, the application of Code Sec. 163(j) and the 100-percent penalty tax on non-arm's-length arrangements between a REIT and its TRS—strike a decent balance between, on the one hand, a REITs' need for flexibility and, on the other hand, the policy objectives of both the corporate tax itself and the 1960 REIT legislation. And the use of TRSs should not be viewed as reducing the corporate tax base, as TRS income is necessarily subject to the corporate tax.

Although the TRS legislation balances REIT flexibility with the policy objectives underlying the corporate tax, it might be possible to modify the TRS rules in a way that further advances those policy objectives. For example, in order to further limit a TRS's retained earnings without subverting the populist/capital markets objectives underlying the 1960 REIT legislation, the TRS rules could be amended to require TRSs to distribute all of their taxable income to the REIT, which dividend would then be subject to the REIT distribution requirement.²³⁶ But even as

the rules are drafted today, we do not see how REITs' use of TRSs could offend tax policy.

2. The Development of Nontraditional Real Estate

One assertion made by some REIT critics as evidence that the REIT rules need to be scaled back is that the IRS has somehow “expanded” or “broadened”²³⁷ the definition of “real property”²³⁸ in order to help “create” new types of REITs. As a threshold matter, this assertion is simply incorrect. Furthermore, even if the IRS had “expanded” the definition of “real property,” the expansion would not pose a policy problem for the reasons explained in Part V.C.2 below.

First, the definition of “real property” has not changed since that term was adopted in final regulations issued in 1962, and the IRS's interpretation of that definition, as expressed in private and published rulings, has remained consistent from then until now.²³⁹ Furthermore, even though the IRS has issued proposed regulations that would simplify the 1962 regulations and streamline and clarify the analytical process used to determine whether or not assets qualify as real estate, the substantive requirements that an asset must satisfy in order to constitute real estate would remain the same, and the proposed regulations ought not produce different results than those produced by the historic ruling policy, which was based on the 1962 regulations.²⁴⁰

Insofar as new types of assets are being classified as “real property,” it is only because those assets are either the product of technological advances made since the 1960s or changes in the regulatory or economic environment that make it possible for one person to own the asset and another person to use the asset. For example, as a result of technological advances, the monstrous radio transmission towers of the 1960s have given way to cell phone towers,²⁴¹ and the pneumatic tube systems and telegraph centers of the 1930s have been replaced by fiber-optic networks and data centers.²⁴² Similarly, as a result of changes in finance and regulation, a power producer need not own the transmission and distribution system that connects its electricity plants to the power grid.²⁴³

In none of these situations did the IRS classify as real estate an asset that would have been classified as non-real estate in 1960 had the asset existed on a stand-alone basis in 1960. Thus, if one were to ask why the list of real estate assets today is different than the list of real estate assets *circa* 1960, the clearest explanation is that technological and other developments since that time have either created real estate assets that did not exist in 1960 or created opportunities for alternate forms of asset ownership that did not exist in 1960.

This is nothing more than an example of the familiar legal problem of having to apply an old law to new facts—the same problem the Supreme Court faces when, for example, it is asked whether the term “search” under the Fourth Amendment includes placing GPS on a suspect's car²⁴⁴ or viewing the suspect's home through a thermal imaging device.²⁴⁵ Even though the drafters of the Fourth Amendment, if they had seen a GPS tracking unit or a thermal imaging device in action back in 1789, may have regarded those technologies as black magic,²⁴⁶ the Court of course did not “change” or “expand” the definition of “search” when it ruled that GPS tracking and thermal imaging constituted a “search.” All it did was apply an old law to new facts. So, too, has the IRS when it has been asked to address new types of real property.²⁴⁷

None of these developments create policy problems. First, each of these developments enable REITs to carry out the populist and capital markets policy objectives underlying the 1960 REIT legislation. These developments provide small investors with access to yield producing asset classes that they could not otherwise access and enable asset owners and sponsors to access the public capital markets. Second, none of these developments run afoul of the policy objectives underlying the corporate tax, because REITs do not accumulate their earnings and any TRS activities are subject to the corporate tax. Third, because these developments all involve real estate assets that are leased to large (typically corporate) tenants, these developments advance the policy objectives underlying the corporate tax by limiting the accumulation of retained earnings inside corporate tenants. Finally, we cannot see how curtailing these developments would advance any policy objective that Congress has articulated.

3. C-to-REIT Conversions and REIT Spin-Offs

This Part goes to the heart of what really seems to concern the REIT critics: C-to-REIT conversions and REIT spin-off transactions. Critics seem to advance two arguments when expressing concern over these transactions: first, the transactions are tax-motivated schemes that do not advance real business objectives and therefore run afoul of corporate tax policy; second, regardless of the existence or nonexistence of real business objectives for the transaction, the transaction results in materially decreased tax revenues for the government. Because Professor Borden has ably addressed the second argument, we will focus on the first argument.

Transactions are typically prompted by a variety of factors, some of which are relevant to our tax policy debate and some of which are not. When it comes to C-to-REIT conversions and REIT spin-off transactions, we think that capital markets

developments²⁴⁸ and the trend toward specialization help explain much of the activity. In addition, in situations where a C corporation is converting into or spinning off a non-traditional REIT, the technological, regulatory and finance developments described above also drive transactions. As discussed below, we do not believe that either factor presents tax policy concerns that undercut the conclusion that REITs should not be subject to the corporate tax.

(a) Capital Markets Factors. Over the years, the capital markets have become comfortable with two ideas that have fostered growth in the REIT space. The first idea is that some businesses can operate most efficiently on a “capital-light” basis by renting rather than owning critical parts of their value chains. The second idea, a corollary to the first, is that other businesses can function profitably by owning critical parts of value chains and charging rent (or some type of rent-like fee) for their use. This means that some companies that would otherwise own the real estate in which they do business will choose to rent instead. When this happens, it creates opportunities for other investors to acquire that real estate. These two ideas, when combined with one another, can explain many C-to-REIT conversions and REIT spin-offs.

Other relevant capital markets factors are the enhanced emphasis that investors place, especially recently, on yield-generating securities²⁴⁹ combined with the changing financial metrics under which public C corporations now operate. In a world where investors are willing to pay a premium for securities that pay a predictable yield, and where capital markets financial metrics are punishing many non-real estate companies that own the real estate in which they conduct business, many C corporations that would in prior times have chosen to accumulate their earnings and operate in C corporation form are pressured to either dispose of their real estate assets, through a spin-off or sale-leaseback transaction, or convert to REIT status, even though the costs of doing so can be quite large and the loss of flexibility can restrain management in significant ways.

(b) Specialization of the Firm and the Separation of Asset Ownership and Usage. American businesses have been trending toward specialization for at least 40 years. That trend toward specialization—a term that we use colloquially to refer to a process in which a business focuses on performing fewer and fewer functions at higher and higher levels of quality—is playing out in the REIT space in three ways that are relevant to the current tax policy debate.

First, as conglomerates and vertically integrated companies become more unwieldy from a management perspective and less attractive from a cost-of-capital or capital-markets perspective, businesses that, in prior times, would

have owned real estate are now encouraged to dispose of that real estate and turn to third-party property owners to fulfill their real estate needs.

Second, as discrete business functions or business units become more narrowly focused, tenants’ real estate needs tend to become more narrowly focused as well. This means that property owners need to develop real estate that is especially suited to the needs of tenants who are searching for narrowly tailored properties.

Third, as property owners develop properties that are more specialized, those properties become suitable for use by a more narrow class of tenants. As property owners become more focused on accommodating the demands of an increasingly narrow type of tenant, the property owners themselves, by necessity, start to become specialized providers of property.

On a stand-alone basis, the first development can lead to REIT spin-offs as conglomerates or vertically integrated businesses narrow their focus to their non-real estate business operations.

The second development can lead to C-to-REIT conversions in situations where a company that at one time operated multiple business lines narrows its focus so that its primary business is real estate and any ancillary businesses can fit inside a TRS.

Each of these cases involve businesses changing the way that they operate in order to enhance efficiency and profits. That’s what businesses are supposed to do.

(c) Policy Implications of C-to-REIT Conversions and REIT Spin-Offs. The developments described above are all driven by business concerns and do not change the manner in which REITs operate. In our view, to the extent these developments are fostering growth in the REIT space, they are advancing the policy objectives underlying the 1960 REIT legislation by providing small investors with access to yield-producing asset classes that they could not otherwise access and enabling asset owners and sponsors to access the public capital markets. More importantly, these developments are advancing the policy objectives underlying the corporate tax, as they are both accelerating the distribution of C corporation E&P through a “purging” dividend, which is a prerequisite for every C-to-REIT conversion and REIT spin-off, and preventing the accumulation of retained earnings by corporate tenants of the REIT, which must pay rent to the REIT, which in turn is distributed to shareholders. In addition, any TRS income would remain subject to the corporate tax, as would any built-in gain recognized by the REIT during the five-year period following the conversion.²⁵⁰ Finally, we have not identified any other congressional objective that would be advanced if these developments

were to be curtailed (or, in the case of REIT spin-offs, any objective to support their recent curtailment as noted in the introductory endnote to this article).

D. Concluding Thoughts on REITs, the Corporate Tax and Modern Developments on the REIT Space

Aside from the impact of false premises and strong words, a good portion of the debate around the tax policy implications of the REIT industry seems to stem from differing levels of comfort and discomfort that debate participants have with progress and change. Some participants seem to be comfortable with the idea that REITs can remain true to the policy objectives underlying the 1960 REIT legislation and the corporate tax while at the same time adapting their asset bases and approaches to tenant relationships in a way that responds to developments in technology, regulation, finance and the capital markets; other participants seem to think that if a particular asset class or operating style did not exist in 1960, then it is verboten for REITs.

The fact that the REIT industry has grown dramatically and that REITs have changed in size, asset-class exposure and operating style over the years cannot, in and of itself, create a tax policy problem. These types of developments should only be viewed as problematic if one of the following things are true: (i) REITs are failing to advance the populist and capital markets policy objectives underlying the 1960 REIT legislation; (ii) REITs are acting in a way that would run afoul of the policy objectives underlying the corporate tax by becoming, or allowing others to become, monopolists that excessively accumulate retained earnings; or (iii) REITs are hindering some other, more important policy goal of Congress.

Each of the recent developments described above enables REITs to carry out the policy objectives underlying the 1960 REIT legislation by providing small investors with exposure to asset classes in which they would otherwise be unable to invest and by enabling asset owners and sponsors to access the public capital markets. Because REITs must still distribute their earnings on an annual basis and may not end a tax year with C corporation E&P, REITs are not running afoul of the policy objectives underlying the corporate tax. Indeed, the REITs described above, through their collections of rent and rent-like fees from other corporations, actively advance those policy objectives by limiting the accumulation of retained earnings inside those corporations.

Finally, if recent C-to-REIT Conversions and REIT Spin-Offs were to be curtailed, newly formed REITs would have a competitive advantage over older C corporation

property owners, which may be direct competitors of the new REITs but could not achieve the tax and nontax benefits of being a REIT. Insofar as Professor Avi-Yonah's "regulatory" view of corporate tax policy is correct, this result would frustrate that policy by hindering the antidote to monopoly—competition.

In our view, the recent developments are a successful example of the tax law remaining true to its underlying policy objectives—*i.e.*, the objectives underlying both the 1960 REIT legislation and the corporate tax—while adapting to changing times. We simply do not see a tax policy problem here.

VI. Policy Recommendations for Rationalizing Our System of Collective Investment Vehicles

Although the REIT critics might not have realized it, the debate they spawned is, at its heart, a debate about collective investment vehicles, what role they should play in our tax system and what set of tax rules should govern them. The debate really involves four questions, each of which is explored below. First, should collective investment vehicles be subject to the corporate tax? Second, if not, what types of income should collective investment vehicles be allowed to receive? Third, what operating model should the tax system adopt for collective investment vehicles? Fourth, what other tax law changes should be adopted and what other issues should be considered in order to enable the collective investment system to function properly?

A. Collective Investment Vehicles Should Not Be Subject to the Corporate Tax

A threshold question in any tax policy debate is revenue—or, more precisely, whether the debate is going to be all or mostly about revenue. We have not considered revenue in this article for three reasons. First, depending on one's perspective, the corporate tax is either a regulatory tax designed to combat monopoly and curb managerial power or the outcome of a political settlement between the government and managers in which corporations pay tax as the price of having the power to retain their earnings. Viewing the corporate tax through either lens, revenue ought to be relevant only to the extent necessary either to achieve the regulatory policy objectives underlying that tax or to impose the proper upfront charge for the flexibility of retaining earnings. Because REITs do not operate in a way that implicates either goal, revenue ought to be irrelevant to an analysis of the proper taxation of

REITs. In other words, if the corporate tax rate is too low, or if the corporate tax base is too narrow, to achieve the policy objectives underlying that tax, then the corporate tax rate or corporate tax base should be adjusted. Neither of those issues, however, should be relevant in any way to the proper taxation of an entity, such as REIT, which does not implicate those policy objectives.

Second, Professor Borden's work covered the question of REITs' impact on tax revenues in a thorough and impressive fashion, as discussed above. Third, debates that are driven by revenue always seem to devolve into a battle of the lobbyists. Because the government possesses both the pen and the gun, it can take money from whomever it wants, and it suffices to say that most people believe that the government should take whatever money it needs from someone else. Given that lobbying is not our forte, our analysis of the proper taxation of collective investment vehicle is framed in terms of traditional corporate tax policy.

As discussed below, we believe that collective investment vehicles, as they currently exist and as they would exist if our policy recommendations were adopted, should not be subject to the corporate tax.

In light of the policy objectives underlying the corporate tax, there is no reason for collective investment vehicles to be subject to that tax. Throughout their history, collective investment vehicles have functioned by acquiring assets or financial instruments that generate returns such as rent, interest, dividends and capital gains and have distributed their cash flow to investors on a regular basis. By distributing their earnings, collective investment vehicles have not implicated the policy objectives underlying the corporate tax.

In addition, to the extent that a collective investment vehicle owns an asset or financial instrument that functions economically as a claim on the income of a corporation—for example, through rent or interest paid by the corporation to the collective investment vehicle—the collective investment vehicle is engaging in activity that limits the growth of the corporation's retained earnings and is therefore advancing one of the policy objectives underlying the corporate tax.

Because collective investment vehicles distribute their earnings on a regular basis and limit the ability of corporations to retain their own earnings, collective investment vehicles mesh nicely with both the regulatory view and the capital lock-in view, both of which focus on retained earnings.

Moreover, collective investment vehicles, by definition, help create a bridge between investors seeking to deploy capital and companies that need capital. By providing that type of bridge, savers can be expected to earn higher

returns and companies can be expected to enjoy a lower cost of capital because both groups are able to transact with each other without having to go through the banking system. Without collective investment vehicles to unite savers and companies, savers would have to deposit funds in a bank, and the bank would then lend funds to companies. That transaction would provide the bank with a profit that reduces the return of the savers, increases the cost of capital of the companies or both. Assuming that the collective investment vehicle is not subject to the corporate tax, the profit that would otherwise go to the bank can be split between savers and companies.

Finally, and perhaps most importantly, the act of collective investment, at its heart, helps achieve socially desirable goals that should be encouraged, or at least not discouraged through the imposition of an entity-level tax. As is reflected in the populist objectives of the RIC and REIT legislation,²⁵¹ the act of collective investment is the primary, and perhaps the only, way that small investors can save their money in a manner that earns a reasonable return without exposing them to levels of risk that would ordinarily be unwise for an investor to assume. A small investor that has only a small amount of savings to invest, say \$1000, will have a difficult time managing its risk if it must invest in assets directly. For this investor, it may be difficult to directly buy enough different stocks to achieve a reasonable level of diversification, and buying a diversified portfolio of real estate would be downright impossible. Without collective investment, our investor has a difficult choice: either purchase an ultra-safe investment such as a U.S. treasury bond (which, while safe, will generate a low return), or gamble on a nondiversified portfolio of directly held assets (which puts the investor at significant risk of losing a large portion of his savings in the event of a downturn in the few areas in which he has invested). But collective investment gives the investor a third option: buy, with thousands of other similarly situated investors, a very tiny share of a diversified and professionally managed portfolio of assets that can earn, over the long haul, a reasonable return while being able to absorb market volatility along the way.

This strategy works well when the only thing cutting into the investor's return is a small fee paid to the professional asset manager. But when an additional 35 percent of the investor's return is diverted from the investor to the government in order to pay corporate-level tax, the investor very well may determine that the risk-spreading benefits of collective investment are not worth the cost of a corporate-level tax. In that case, the investor is left with its original choice between, on the one hand, very safe but low-yielding investments and, on the other hand, very

risky but (potentially) higher-yielding investments. Those who anticipate needing more than the returns generated by the safest investments in order to save for expected or unexpected life events—such as the acquisition of a home, the education of one’s children, and one’s retirement—may opt for the higher-risk approach. We would expect that most would agree that it is socially and economically undesirable for small investors to use modest savings to make high-risk investments. Fortunately, collective investment vehicles can give these investors a safer alternative with which to achieve their goals. The imposition of a corporate tax, however, would significantly impede the ability of collective investment vehicles to do so. Indeed, this is one of the main premises underlying subchapter M.²⁵²

Collective investment vehicles are thus beneficial for a number of different reasons. They do not operate in a way that implicates the policy objectives underlying the corporate tax and, indeed, often times affirmatively help advance those objectives. Collective investment also helps develop our capital markets, which necessarily helps both savers and businesses, and can foster socially desirable goals associated with saving money for future needs without bearing unreasonable levels of risk. These types of activities should not be punished or discouraged through the imposition of a corporate tax.

B. What Type of Income Should Collective Investment Vehicles Earn and How Should They Earn It?

1. Moving Beyond the Words “Active” and “Passive”

Before discussing the types of income that collective investment vehicles should be allowed to earn, we want to focus on what types of activities collective investment vehicles should be allowed to pursue in order to earn that income. That, in turn, requires us to focus on the one aspect of the REIT critic argument that we have alluded to but have not yet addressed—the distinction between “passive” and “active” income.

In expressing their concern about the role of modern REITs in the tax system, some REIT critics advance the idea that “investment entities” must remain “passive” in nature in order to be exempt from the corporate tax, while “operating entities” are “active” in nature and therefore must be subject to the corporate tax.²⁵³ A number of recent articles seem to suggest that REITs are no longer “passive” because, through the use of TRS structures or other developments, they have become “active.” These articles advance both assertions without defining the terms “passive” and “active.”

But these terms are useless as criteria for distinguishing between *activities* that should be subject to the corporate tax and activities that should not, except in the broadest sense. Like many other terms in the 1960 REIT legislation, the term “passive” did not originate in 1960. At the time of the 1936 RIC Legislation, “passive” investment was to be distinguished from “active” investment based on the degree to which an investment trust had the power to control its portfolio companies through the ownership of voting shares. The 1936 RIC Legislation’s requirement that an investment trust not own more than 10 percent of its portfolio company was aimed precisely at curtailing this sort of “active” control, which Congress worried could lead to monopoly.²⁵⁴

A RIC’s ability to control its portfolio companies has everything to do with the stake it holds; it has little to do with the nature of its activities with respect to those companies. Suppose there are four corporations in the United States engaged in business X and a RIC acquires 100 percent of the stock of all four corporations. The RIC would then be in a position to vote its shares in favor of the same directors for all four companies.²⁵⁵

The RIC in this example could simply collect and distribute to its investors the dividends received from those corporations, without taking any further action. In modern parlance, the RIC would be considered a “passive” investor in securities because the RIC simply purchased and voted the stock of four corporations, collected and distributed the income earned on that stock and took no further action. In 1936 parlance, however, the RIC would be considered an “active” participant in the market because, by virtue of its ownership of every corporation in a line of business, the RIC sat atop a monopoly. The fact that the RIC did nothing other than vote its shares and collect and distribute dividends was irrelevant to the classification of the RIC as “active.”

Once we move beyond a discussion of monopoly power, the “active/passive” distinction has nothing to do with the policy objectives underlying the corporate tax. The corporate tax was enacted to enable the government to reach corporate retained earnings. Entities either retain their earnings or they do not, and the concepts of “active” and “passive” have nothing to do with the existence or absence of retained earnings.

Moving from etymology to current usage, the words “active” and “passive,” as they have come to be used in the modern debate, are often times more than useless—they are downright dangerous. That is because, although these words have no real meaning in the tax policy sense, they have the ability to conjure up enough of a mental image that many participants in the debate come away thinking that they know what these words mean when, in reality, each participant is likely to have a different image in

mind. In the end, it is highly doubtful that anyone using the words “passive” and “active” to distinguish between those entities which should and should not be taxed could craft legal definitions of those terms without relying on a facts-and-circumstances approach. In that respect, distinguishing between “active” and “passive” income, as those terms are used in the modern debate, is much the same as distinguishing between art and pornography. The tax system cannot function in a rational way if it has to rely on these types of distinctions to draw the line between entities that operate within and without the corporate tax.

To illustrate the uselessness and dangerousness of the active/passive distinction, consider the classic example of a supposedly “passive” entity—the RIC. Many commentators will look at a modern REIT, observe a TRS with employees who are “doing things” (*e.g.*, managing properties, providing services, *etc.*) and advance an anti-REIT argument along the following lines: “Because REITs are doing things with their own employees, the REITs are active, unlike RICs, which by definition are passive. That is why REITs should be subject to the corporate tax while RICs should remain exempt.”

Those words create images in readers’ minds and actually sound plausible until one realizes that RICs have always “done things” in order to make money and are “doing things” right now in order to make money. With the exception of index funds, which are designed to hold a static basket of securities that changes only as the securities comprising the underlying index are changed, RICs generally do not consist of static pools of securities. It is difficult for a mutual fund manager to justify its fee structure if all it does is keep an eye on a pool of securities that never changes.

RIC managers exist in order to develop and implement investment strategies, and they cause the RICs that they manage to buy and sell securities and do other things in furtherance of those strategies. Thus many, if not most, nonindex fund RICs are engaged in the trade or business of trading in stocks and securities. Many RICs, acting through their external managers, will also investigate securities for potential investment, actively monitor the companies in which they invest, engage with the directors and chief officers of the companies in which they invest, and occasionally push directors to take action advocated by the RIC. The fact that a RIC might do these things through an external manager acting as agent of the RIC is irrelevant to the conclusion that, for tax and commercial purposes, the RIC is out there in the world “doing things.”

The activity level of debt-focused RICs provides an even better example of the extent to which RICs are “doing things.” A bond fund functioning in RIC form may,

through its agents, negotiate the terms of debt instruments directly with borrowers or their agents and engage in other activities that are typically viewed as a “loan origination business” in tax parlance.²⁵⁶ This type of activity is viewed by the IRS as a trade or business,²⁵⁷ and it would not be a stretch to say that certain RICs are part of the so-called shadow banking system.

Perhaps, the best example of RICs that are “doing things” are business development companies (BDCs) that operate in RIC form (“BDC RICs”). A BDC RIC is basically a commercial lender that engages in lending transactions directly with customers and relies on the commercial debt markets rather than traditional retail depositors in order to fund itself. A BDC RIC, almost by definition, is a type of bank, and banks are certainly “doing things.”²⁵⁸

None of this is meant as a criticism of the RIC vehicle. On the contrary, these are simply facts in the RIC space, and it is helpful to bear that in mind whenever a commentator calls out RICs as the “passive” counterpoint to those “active” REITs that need to be reined in.

In reality, the idea that we can define a real estate company as “active” or “passive” depending on whether it has “employees” or whether it “does things” has proved difficult since the early 1960s. For example, in Rev. Rul. 67-353, the IRS ruled that REIT trustees could “contract for the construction of an office building on land owned by the trust without adversely affecting [the trust’s] qualification as a real estate investment trust,” notwithstanding the rule that REIT trustees could “not directly manage or operate the trust’s property.”²⁵⁹ We are not sure what Congress had in mind when it described REITs as passive entities, but from our perspective, constructing a building certainly seems active.

Sometimes, rather than directly comparing RICs and REITs, the REIT critics compare different types of REITs and conclude based on the comparison that some of the modern REITs are abusive. This occurred recently in the case of data center REITs, which were alleged by some REIT critics to have crossed the line from “passive” landlords to “active” electricity companies.²⁶⁰

As described above, data centers are buildings that provide a specialized function—they are tailored to house the computer servers on which every major modern business relies. In order for a computer server to carry out its function, at least four things need to be true—the server needs to be located indoors (they do poorly in the rain); the server needs to be plugged into an outlet; the room needs to be kept cool so that the server will not overheat; and the server needs to be connected to the internet so that employees who work in other locations can access the data located on the server. Not surprisingly, data centers require electricity and Internet connectivity—or, more

precisely, lots and lots of electricity and extremely good internet connectivity.

In addition to highlighting the aversion to change and specialization exhibited by many REIT critics, the question of whether data centers are really electricity companies goes to the heart of why the active/passive distinction is so dangerous. For example, assume that: (i) REIT 1 owns a 50-story office tower on the water front, next to the train station and the expressway ramps, smack in the middle of the nicest and most desirable part of downtown; (ii) each floor has 10,000 square feet of leasable floor space, for a total of 500,000 square feet; and (iii) Tenant is a large investment advisor and broker dealer that needs 400,000 square feet of space for office/conference space and 100,000 square feet for its computer servers.

In this situation, if Tenant were to lease all 50 floors of the building, using the upper 40 floors for office/conference space and the bottom 10 floors to house its computer servers, it is impossible to see how the provision by REIT 1 of sufficient electricity to fuel all of Tenant's needs would somehow result in REIT 1 stepping across the "active/passive" line (wherever that happens to be) and morphing from a commercial landlord into an electricity company. We cannot imagine a court reaching that result.

But, of course, the Tenant in this example would not want to rent 10 floors of high-end office space in order to house its computers. The high-end office space is too expensive, and Tenant would rather seek out data center space in a more efficient location. At this point, specialization starts to play a role in two respects. First, if REIT 1 makes its money by leasing high-end office space in the best parts of the towns in which it operates, its executives and business people have probably been focusing on that segment of the market for most of their careers and probably do not know much about data center properties in more efficient locations. Second, Tenant is likely to be sophisticated enough to know that, in terms of cost and expertise, REIT 1 is not the place to go for its data center needs.

In the end, Tenant is going to want to rent 400,000 square feet of high-end office space from REIT 1 and 100,000 square feet of data center space from another landlord, very likely a REIT, much the same way as Tenant might hire one law firm for its SEC regulatory work and another law firm for its employee benefits work. From a tax policy perspective, Tenant is going to use the same amount of electricity whether it rents all 50 floors of REIT 1's waterfront office building or, alternatively, the top 40 floors of REIT 1's office building and 100,000 square feet of floor space in another REIT's data center building. We do not see why in either case the provision

of sufficient electricity to Tenant should cause either REIT to trip over some imaginary line into the world of the "active" electricity business. This outcome makes no sense from either a technical perspective or a policy perspective.

It is no surprise that policy makers and commentators alike have struggled with the passive/active distinction, especially as it is used to distinguish between interest, which seems to be "passive" in all cases, and rent, which some people view as "passive" and others view as being either "active" or "passive" depending on the circumstances. In an economic sense, however, there is no meaningful difference between what tax lawyers call interest and what we call rent—one is a payment received by a money owner for the use of money and the other is a payment received by a property owner for the use of property.²⁶¹ Interest and rent are both paid and received in exchange for the use of capital, and it is difficult to create a meaningful distinction between the two that makes sense from a tax policy perspective. From what we can tell, the only people who have gotten the rent/interest analysis correct are economists, who generally use the term "rents" to describe to all returns on capital, whether couched as rent, interests, dividend or royalties for commercial purposes.

Returning to our profession, we think that, beyond guarding against the creation of monopolies, the very notion that business entities such as RICs or REITs could be classified in a meaningful way from the tax policy perspective as "active" or "passive" was never helpful, and the notion, to the extent used outside the monopoly context, ought to be discarded once and for all.

2. A New Way to Think About Collective Investment Vehicles

If the current policy debate around REITs makes one thing clear, it is that we need a new way to think about collective investment. The REIT critics are not wrong for wanting to police the line between the corporate tax system and what lies beyond its borders. The difficulty with the REIT critics' approach, however, is that they have been focusing too much on what a REIT does in order to earn income and not enough on the type of income the REIT is earning.

Collective investment has always been about using saved money to earn more money by letting someone else use the saved money until it is needed to fund consumption. The concept of saving some money now so that you can use it later is as old as commerce itself. Practically speaking, the only difference, aside from risk, between depositing money in a bank and depositing money in some form of collective investment is that, through the process of collective investment, small investors can team up with one another and with large institutional investors in order to

pursue a larger variety of investments that may offer greater and more diversified returns.

Given that the act of participating in collective investment has been viewed by policy makers as something that ought to be encouraged, the income of vehicles for collective investment has historically been taxed only once, at the investor level. If collective investment is to be encouraged and different types of collective investment activity are to be taxed equally, then the process of identifying what is and what is not collective investment ought to focus on the nature of the income being earned rather than on what types of assets the entity owns or on how many things need to be done in order to earn the income.²⁶² In other words, there is nothing inherent in the act of doing something that changes the nature of a return from the type of return that a collective investment vehicle should be able to earn without paying a corporate tax into the type of return that can only be earned through a C corporation.

All of this leads to four conclusions that form the basis of our policy recommendations. First, to the extent that government views the practice of saving as beneficial to society, it follows that collective investment is a socially desirable activity that ought to be taxed only once, at the investor level. Second, so long as collective investment vehicles operate in a way that does not offend the policies underlying the corporate tax—*i.e.*, by distributing all of their earnings and operating in way that does not foster economically harmful behavior such as the creation of monopoly power or give rise to inappropriate influence on government behavior—the vehicles themselves ought not be subject to the corporate tax. Third, growth in the number and variety of collective investment vehicles can advance the policy objectives underlying the corporate tax by encouraging corporations to own fewer assets and pay rent for the assets that they use, a process that would inhibit the accumulation of retained earnings. Finally, if we are to draw a workable line between collective investment vehicles that ought not be subject to the corporate tax and those entities that should be subject to tax, then we need to focus on the nature of the income earned by the collective investment vehicles (*e.g.*, rent, interest, dividends and capital gains) and the distribution of that income on a regular basis, rather than on words that defy definition, such as active or passive, or the actions that the collective investment vehicle needs to take in order to earn the income in the first place.

C. Picking the Right Model for Collective Investment Vehicles

Once we decide to expand collective investment vehicles to include additional asset classes, two new questions arise.

First, what types of income should the vehicle be allowed to earn? Second, how should the vehicles operate? Each of these questions is explored below.

1. Income Classes for Collective Investment

If the tax system is to have any role in simultaneously encouraging collective investment and discouraging the accumulation of earnings inside corporations, the tax system needs to encourage the creation of private entities that can effectively impose their own type of tax on the corporate sector in the form of rent and interest, and these entities should be allowed to sell their income producing assets at a gain, all without being subject to the corporate tax. The interest component is easy enough to address conceptually, as RICs and REITs can already earn interest income without being subject to the corporate tax. The significant changes would take place in the rental and asset gains areas.

(a) Rental Assets. In terms of rental assets, we suggest that collective investment vehicles be allowed to own and lease to unrelated third-party users any type of asset that can be owned by a group of investors and leased to a corporation in exchange for a rent-like payment.

The two difficult questions here concern the type of assets that the entity could own and lease and the type of services the entity would be able to provide directly, as opposed to through a TRS.

In terms of tangible assets, the entity would be able to own and lease any type of building, plant, machinery or equipment; any type of transportation asset that a corporation needs to use in order to function; and any privately owned infrastructure asset that a corporation needs to use in order to pursue its own business.

Given the increasingly critical role of intellectual property in our economy, we do not think it makes sense to prohibit collective investment vehicles from owning intangible assets. That said, intangible assets present uniquely complex questions in this context, and there are two basic models we could use to deal with them—the simple model and the complex model.

Under the simple model, a collective investment vehicle would be allowed to own and license to third parties any type of intangible asset for which no further development work is necessary, and the entity would not be allowed to develop or improve intangible assets, either directly or through a “TRS.” Under this model, the entity could own assets such as fixed patents; copyrights on items such as books, music and movies; and other business-related intangibles that are capable of being owned by one person and licensed by another. This model would be consistent with the idea of a collective investment vehicle earning money

by allowing a corporation to use its capital in exchange for rent, which advances the policy objectives underlying both collective investment and the corporate tax.

Under the complex model, the entity would be able to own, license and develop its own intangible assets, meaning that the entity would be able to do R&D work for its own account and license the fruits of that R&D to third parties. The main danger with this model is that developing intangible assets (*e.g.*, software) for licensing to third parties is the type of business that tends toward monopoly, which can bring the collective investment vehicle concept into direct conflict with the policy objectives underlying the corporate tax. If the complex model is to be pursued, then at a minimum the Code would need to adopt the safeguards outlined below.

In the end, we prefer the simple model because it is more consistent with the use of a collective investment vehicle as an entity that provides financing in exchange for a usage fee, which is what collective investment is supposed to be about.

(b) Sale Assets. The concept of collective investment vehicles selling assets raises two policy concerns, both of which can be addressed by existing provisions of the REIT regime.

The first policy concern is that, if collective investment vehicles are permitted to sell assets to customers in the ordinary course of business, they would be able to compete unfairly with manufacturers who are operating in C corporation form. The second policy concern is that manufacturing businesses by their nature are scalable and tend toward monopoly, which implicates the policy objectives underlying the regulatory view of the corporate tax.

Both of these concerns could be addressed through existing REIT provisions by imposing the 100-percent prohibited transactions tax on any sale by a collective investment vehicle of inventory or assets held for sale to customers in the ordinary course of a trade or business. In the case of assets that are produced or manufactured by the collective investment vehicle or one of its TRSs, the 100-percent tax could be applied regardless of whether the property is sold at the collective investment vehicle level or the TRS level. This provision would likely prevent a collective investment vehicle from manufacturing or producing assets either directly or through a TRS, and that is fine with us. To the extent the corporate tax is aimed at discouraging monopolistic businesses, we think that it makes sense as a policy matter to lock out of the collective investment vehicle space manufacturing businesses that tend toward monopoly.

(c) Additional Safeguards. If we are to expand the role of collective investment vehicles beyond real estate and

securities, we need to be careful that the policy objective of expanding collective investment does not subvert the policy objective of discouraging retained earnings and subjecting to the corporate tax those businesses that tend toward monopoly.

The 100-percent tax on prohibited transactions, as discussed above, can play a role in balancing those objectives, but that tax is just part of the picture. The other part, we believe, lies in tweaking the TRS rules for the new businesses that will be able to operate in a new collective investment vehicle regime.

REITs are thus often a good way to invest in real estate, but in many cases a partnership or a C corporation will be a better investment vehicle.

First, in order to ensure that a collective investment vehicle is not retaining earnings, we would require the “TRS” to distribute all of its taxable income *and excess earnings* to the collective investment vehicle. This rule would apply to all “TRSs,” both foreign and domestic, and in the case of a foreign “TRS,” the TRS-level distribution requirement would apply even where the income earned by the foreign “TRS” is not includable in the income of the collective investment vehicle under Subpart F. The requirement to distribute earnings at all levels of the collective investment vehicle structure would help ensure that the policy objectives underlying the corporate tax are not subverted by the expansion of the collective investment vehicle concept.

Second, we would apply the existing related party rent and Code Sec. 163(j) limitations to the new vehicles and would expand the 100-percent tax on non-arm’s-length transactions to encompass any Code Sec. 482 adjustment between an expanded collective investment vehicle and its TRS.

This brings us to one of the more contentious issues of the current debate—the provision of services. In our view, any services provided to a user of an asset, whether tangible or intangible, should be provided through a TRS of the collective investment vehicle or through an independent contractor from which the collective investment vehicle does not derive any income. The reasoning here is that, if collective investment vehicles were allowed to own and lease any non-real estate asset and simultaneously “bundle” assets and services, they might be able to compete unfairly with taxable providers of similar services. Requiring a “TRS” to provide all user services and policing

that requirement with a 100-percent penalty tax on any Code Sec. 482 adjustment in favor of the “TRS” would go a long way toward addressing concerns around the tax system providing an unfair advantage to one entity over another. This is the same theory underlying the TRS rules and the regime for “unrelated business taxable income” (UBTI), and we think that theory applies with equal force here. These rules, when coupled with the TRS-level earnings distribution requirement and the other safeguards described above, would also help ensure that an expanded collective investment vehicle concept does not run afoul of the policy objectives underlying the corporate tax.

Although these requirements are stricter than those applicable to REITs, we think they are necessary to ensure that collective investment vehicles are earning returns in respect of rent and interest and that they are acting in a way that does not run afoul of, and in fact helps advance, the policy objectives underlying the corporate tax.

2. Choosing the Best Operating Model

Expanding the REIT concept to additional asset classes is a quixotic venture to say the least, and if an expansion were to require a brand new tax infrastructure, the entire venture would likely collapse under its own weight. Therefore, we think that if the REIT concept is to expand, it should do so through an existing collective investment vehicle under the Code. This Part reviews the existing vehicles and concludes that, if the REIT concept is to be expanded, the best way to do that is by amended Subchapter M, as the other collective investment vehicles are too narrow for the task at hand.

(a) Existing Operating Models for Collective Investment. Next to REITs, the oldest collective investment vehicle is probably the grantor trust. A grantor trust can hold a variety of assets, but is often used to hold debt instruments in order that the interest payments on those instruments may qualify for the portfolio interest exemption. The beneficiaries of a grantor trust often share in distributions on a pro rata basis, and the ability to create multiple classes of ownership is extremely limited. In the end, the grantor trust is a plain vanilla, “set-and-forget” type of vehicle and is useful only for the widespread ownership and disposition of a static pool of securities or income-producing financial instruments and the distribution of the proceeds attributable to the ownership and disposition of those securities or instruments.

Real estate mortgage investment conduits (REMICs) can be thought of as more useful versions of the grantor trust, but only in the real estate mortgage space. REMICs are vehicles that own mortgages on real property. REMICs are allowed to issue “regular” interests that are automatically classified as debt instruments for tax purposes. A REMIC

sponsor can create a virtually unlimited variety of “regular” interests, which allows for the intricate slicing and dicing of mortgage cash flows in ways that are not achievable in the grantor trust vehicle. Beyond that, the activities of a REMIC are almost as limited as those of a grantor trust, and most folks view REMICs as “set-and-forget” vehicles that are only suitable for holding a static pool of securities.

Master limited partnerships (MLPs) are entities that are organized as state law limited partnerships or limited liability companies. Because MLP units are traded on some type of stock exchange, MLPs are subject to tax as corporations unless they satisfy a 90-percent passive income test. The income test itself represents a smattering of items, some of which make sense based on the existing treatment of other entities (*e.g.*, income that would qualify for a REIT or RIC is generally qualifying income for an MLP), while others make sense only in the context of broader policy objectives (*e.g.*, promotion of financing for natural resource activities).

(b) Expanding Subchapter M. Anyone who works in Subchapter M acknowledges that this is a Tylenol-intensive practice area. The sheer number of technical requirements and unexpected results produced by those requirements can be either mind-boggling or mind-numbing, depending on the day.

That being said, for a variety of reasons, from an investor and capital markets perspective, expanding the universe of collective investment vehicles by expanding Subchapter M is probably the easiest and best way to carry out our policy recommendations. First, Subchapter M entities provide significant flexibility in terms of capital structure, corporate governance and marketability, as they can be organized as corporations, limited partnerships, limited liability companies and business trusts, and can have a wide variety of share classes.

Second, the Subchapter M entities provide a level of operational flexibility and investor friendliness that the other current collective investment vehicles cannot come close to matching. For example, because they can organize as state law business entities, Subchapter M entities can buy, sell and operate a variety of assets, which is something that grantor trusts and REMICs cannot do. Second, because Subchapter M entities are treated as corporations for most tax purposes, they can take advantage of the Subchapter C infrastructure for purposes of carrying out acquisitions, dispositions and consolidations of other entities. Although we have spent most of this article arguing that the Subchapter M entities ought never have been subject to the corporate tax in the first instance, we now have 80 years of rule-making and judicial doctrines behind us and, from an administrative perspective, we ought not reinvent an entirely new regime

when we can rely on a regime that has already been developed. Finally, the Subchapter M entities pay out dividend income and report on Form 1099, which makes them more tax efficient for foreign and tax-exempt investors and easier to deal with for individual investors.

D. Ancillary Policy Issues

1. What Other Changes Need to Be Made in Order to Ensure the Success of Collective Investment Vehicles?

Although expanding Subchapter M sounds simple, such an expansion would create a ripple effect of questions throughout the Code, some of which are addressed here.

First, and perhaps most importantly, if one of the reasons behind the expansion of Subchapter M is the desire to encourage corporations to rent rather than own their assets, then we need to reassess those provisions of the Code that encourage corporations to buy assets. For example, if we want to encourage Subchapter M vehicles to acquire equipment and rent that equipment to corporate users, it makes sense to eliminate the bonus depreciation provisions that would otherwise encourage corporations to buy that equipment. In addition, to the extent the corporate tax was designed to inhibit the accumulation of retained earnings, it would also make sense to revisit other noncash deductions, including the deduction for accrued but unpaid original issue discount on corporate debt.

To the extent that Subchapter M is expanded to allow Subchapter M entities to earn the types of income currently being earned by MLPs, then investors in those MLPs may suffer economically as their investor-friendly Subchapter M counterparts begin to come on line and compete for capital and assets. On that score, it would be appropriate to modify the MLP rules in order to enable MLPs to adapt to an expanded Subchapter M world. Among other things, the MLP rules would be changed so that: (i) MLPs could convert into Subchapter M entities on a tax-deferred basis, including tax deferral for MLP investors who have “negative tax capital” in their MLP units; (ii) MLPs could report net income and distributions on Form 1099 in order to relieve U.S. individual, tax exempt and non-U.S. investors from state filing obligations, UBTI and ECI, respectively; and (iii) MLP distributions could be treated the same as RIC distributions for purposes of Code Sec. 1441 withholding, including pursuant to treaties.

It might also be appropriate to focus on whether investors such as pension funds and foreign governments should be allowed to receive dividends from Subchapter M entities without paying Federal income tax. We think the issue of

foreign governments is more political than tax policy, and leave the question to the politicians; in any event, in our experience, the level of sovereign investment is not big enough to move the net tax receipts needle for a country of this size in any meaningful way. On pension funds, the bottom line is that the income that moves from a REIT to a pension fund will eventually be taxed at ordinary rates when the money moves from the pension fund to the pension beneficiary. This issue is therefore one of timing, and, given the social policy objectives underlying the tax treatment of pensions, combined with the struggles that pension funds already face in satisfying future commitments, we think the better view is to defer the taxation of the income until the pension fund makes distributions to beneficiaries.

2. Shareholder-Level Changes

The expansion of the REIT operating model to new asset classes can be expected to have ripple effects at the shareholder level. The first one that comes to mind is the dividend withholding tax on non-U.S. investors. REIT dividends are generally subject to 30-percent withholding, which may be reduced to 15 percent under a treaty. By contrast, C corporation dividends, although subject to a nominal 30-percent withholding rate, are eligible for more generous reductions, and in certain cases outright exemptions, under our tax treaty network.

As discussed above, our recommendations are policy-based and not revenue-based (*i.e.*, although our recommendations could reduce revenue in certain cases, we are not trying to achieve that result and would be completely happy if revenue remained the same or increased). With that in mind, we would suggest that our treaties be amended where possible to impose on non-U.S. shareholders of a collective investment vehicle the same withholding tax burdens to which they would be subject if that entity were taxed as a REIT. Where it is not possible to amend treaties, we suggest that the enabling legislation impose that increased tax on the collective investment vehicle itself and permit that vehicle, through its charter documents, to offset the entity-level tax against the distributions otherwise payable to the relevant non-U.S. shareholder. This mechanism already exists in the mortgage REIT space, and many mortgage REIT charters already include the enabling language.

3. What About Subchapter M Entities That Do Business with Noncorporate Tenants and Borrowers?

To this point, this article has focused on REITs that interact primarily with corporate tenants, as those REITs have been the focus of the recent policy debate.

Notwithstanding that focus, we think that REITs which focus on noncorporate tenants and borrowers should continue to be taxed under Subchapter M in light of the policies underlying the 1960 REIT legislation and the historic treatment of collective investment vehicles described above. Although these entities might not inhibit the accumulation of retained earnings, they do serve ancillary social and economic objectives, including the provision of finance to the residential mortgage market and the provision of rental real estate to individuals. Because REITs that focus on noncorporate tenants and borrowers advance multiple favorable policy objectives, and we are unable to articulate any policy objective that would be advanced if these entities were eliminated, we think they should continue to function as they currently do.

4. Should We Provide All Corporations with a Dividends Paid Deduction or Otherwise Incentivize the Distribution of Earnings?

One obvious question underlying our analysis is this: If the corporate tax is all about limiting the accumulation of retained earnings, then why do we not simply encourage all corporations to distribute their earnings, either through a dividends paid deduction coupled with a punitive tax on retained earnings or through an outright prohibition on retained earnings? While these mechanisms would work differently, they would each advance the policy objectives underlying the corporate tax.

There are experts in business and finance who would argue that retained earnings help foster innovation and increase economic growth and that corporations' ability to retain earnings should not be undercut. Although an analysis of those arguments is beyond the scope of this article, we would like to make one simple point: any negative effects of retained earnings aside, we do not think it makes sense to adopt rules to encourage or require all corporations to distribute their earnings before we have analyzed the consequences of those distributions and, if necessary, amended our laws and treaty network to ensure that those effects do not create other unforeseen problems.

One possible consequence could arise from the existence of multinational entities (MNEs). To illustrate the potential of MNEs to create harmful effects, assume that: (i) Corporation X is a publicly traded U.S. technology company that has \$10 billion of untaxed retained earnings in a Luxembourg CFC; and (ii) Congress passes a law that allows Corporation X to claim the dividends paid deduction and subjects Corporation X to an excise

tax (on top of the 35-percent corporate income tax) on retained after-tax earnings.

If this law were to go into effect, Corporation X could become a takeover target for a large foreign corporation. For example, if a U.K. competitor corporation were to acquire Corporation X in a noninversion transaction (so that U.K. competitor is still treated as a foreign corporation for U.S. tax purposes), it could cause Corporation X to move the \$10 billion from Luxembourg to Corporation X and from Corporation X to the U.K. parent on a tax-free basis. That is because, although the distribution of the \$10 billion from the Luxembourg CFC to Corporation X would be includable in Corporation X's gross income, the offsetting dividends paid deduction would wipe out that income. If the U.K. parent is entitled to the 0-percent dividend rate under the U.S.-U.K. income tax treaty, then the \$10 billion would have escaped U.S. tax and landed in the hands of a non-U.S. corporation. In that situation, unless U.K. law were to impose its own disincentives to the movement of earnings from the U.S. to the U.K. or to the retention of those earnings at the U.K. parent level, the change in U.S. law would have simply shifted the managerial power and agency cost issues associated with the \$10 billion of existing retained earnings, plus 100 percent of all net earnings from the future operations of Corporation X, from the managers of Corporation X to the managers of the U.K. parent. Alternatively, even if Corporation X were to pull the \$10 billion upstream from the Luxembourg CFC and distribute that money to its own historic shareholders, the U.K. parent, in the absence of some type of U.K. legal disincentive, could still benefit from acquiring Corporation X, as post-acquisition non-U.S. earnings could move from the U.S. to the U.K. parent and rest at the U.K. parent level without any U.S. income or withholding tax.

In an environment where barriers to the movement of capital are reduced by treaties and laws that encourage cross-border finance, a U.S. law change that simply shifts \$10 billion of retained earnings from a U.S. corporation to its non-U.S. parent does not accomplish anything positive from the U.S. policy perspective and may potentially make us all worse off by turning large sectors of corporate America into takeover bait for non-U.S. competitors.

This is not to say that we should never consider moving toward a world where corporations are discouraged from retaining their earnings. Rather, if we are to consider doing that, we need to study and address the consequences of tax treaties and trade agreements. In the end, it may well be a system that discourages corporations from retaining their earnings is akin to pacifism—it works great in theory, but only works in practice if everyone adopts it at the same time.

VII. Conclusion

Although this article is excruciatingly long, the two main points are incredibly simple. First, if we are going to have a tax policy debate that has the potential to pose an existential threat to the REIT industry, which among other things is vital to the U.S. economy, we ought to use the correct premises to frame the debate. Second, the most recent tax policy debate on the proper taxation of REITs has been based on two flawed premises—that REITs should be subject to the corporate tax in the first instance and that recent trends in the REIT space create a material drain on the fisc. We have left the second premise to Professor Borden, who did a far better job than we ever could of addressing its faults.

This leaves us to debunk the first premise. On that score, the simple fact of the matter is that REITs, both historically and currently, distribute their earnings and operate in a way that discourages corporations from retaining their own earnings. These facts lay the groundwork for four simple conclusions. First, in light of the policy objectives underlying the corporate tax, REITs should never have been subject to the corporate tax. Second, in light of those policy objectives, when combined with the policy objectives underlying the 1960 REIT legislation, REITs should continue to not be subject to the corporate tax. Third, recent developments in the REIT space represent a regulatory regime and a regulated industry relying on long-standing legal principles to respond to developments in technology, finance and the capital markets. Fourth, the tax system should encourage the growth of REITs, as payments made by corporations to REITs limit the ability of corporations to retain earnings and thus advance simultaneously the policy objectives of both the corporate tax and the 1960 REIT legislation.

These four conclusions lead us to three observations. First, it ought to be evident at this point that a combination of events—including the Supreme Court’s decision in *Morrissey*, Congress’ immediate but partial repeal of *Morrissey* with respect to RICs and the development of the now discredited and discarded corporate resemblance test—have done significant damage to the REIT industry by skewing the policy debate against REITs. Second, those events may have done their worst damage by preventing the creation and development of other types of collective

investment vehicles that were impossible to construct due to the *Morrissey* decision and the corporate resemblance test. The third observation is an outgrowth of the second: From the perspective of sound tax policy, which requires that similar activities be taxed in the same way, the real problem with the REIT regime is that it is too narrow and excludes a number of economically similar asset classes that would be appropriate and suitable for inclusion in a REIT-like collective investment vehicle.

These observations lead us to our policy recommendation—in order to advance the policy objectives underlying the corporate tax and our traditional treatment of collective investment vehicles, as well as to create a coherent system for the taxation of collective investment vehicles, the REIT regime should be expanded (to the extent described in Part VI above, and taking into account the relevant limitations and precautions) to include any asset that can be owned by one entity and leased to another or owned by one entity and financed by another.

REITs are simple vehicles, and talking about them in the context of corporate tax policy should not be as difficult as it has been these past few years. We think the difficulty results primarily from a combination of adverse intellectual presumptions which frame our thought process as it relates to REITs and meaningless but powerful words such as “active” and “passive.” This combination has created a false premise for the tax policy debate on the proper taxation of REITs, and it is not possible to have a productive tax policy debate when we are starting from the wrong place intellectually.

It is time to reset the debate and remove from our minds the ideas that REITs should have been subject to the corporate tax in the first instance and that words such as “active” and “passive” can help us think about which activities REITs should and should not be allowed to pursue.

If our profession wants to debate whether REITs should be included in the corporate tax base due to concerns around tax revenue or some perceived change in the policy objectives of the corporate tax that is fine with us. Our views on corporate tax policy and the proper taxation of REITs are set out above, and we assume that others will express different views. All we ask is that the debate be framed in terms of whether REITs, which should never have been subject to the corporate tax, should now be brought within that tax.

ENDNOTES

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As this article was going to press, Congress enacted the Protecting Americans from Tax Hikes (PATH) Act of 2015 (Division Q of P.L. 114-113). Among other amendments effected by the Act, Section 311 of the Act added Code Sec.

355(h)(1) (which prevents REITs from engaging in tax-free spin-offs) and Code Sec. 856(c)(8) (which generally prevents C-to-REIT conversions if the converting corporation had spun off, or had been spun off, from another C-corporation

within the past 10 years). The portions of this article dealing with REIT spin-offs and C-to-REIT conversions should be read as a critique of these new provisions. We view them as a product of a debate that has been based on a false premise and conducted in a way that is inappropriately skewed against REITs. This is what happens when an institution loses sight of the policy objectives underlying its legislation.

¹ Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 469 (1897).

² The House report to the REIT legislation states—
... the equality of tax treatment between the beneficiaries of real estate investment trusts and the shareholders of regulated investment companies is desirable since in both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources. These advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangements

H.R. Rep. No. 86-2020, 1960-2 CB 731, 820.

³ For example, equity REITs generally focus on the acquisition, development, ownership and rental of real estate, while mortgage REITs generally focus on lending to people and businesses that acquire, develop or own real estate. Some equity REITs specialize by focusing on assets of a specific use, such as office buildings, residential apartments, shopping malls or, more recently, data centers or prisons. Some may specialize even further, for example, by focusing on a specific segment of a particular market, such as Class A apartments in urban locations or Class B/C apartments in suburban locations. In terms of shareholder-level characteristics, a REIT can be classified as publicly traded or privately owned or by reference to the tax statuses of its shareholders (e.g., a “domestically controlled REIT” or a “pension-held REIT”). See, e.g., Code Sec. 897(h)(2), (4) (special rules under the Foreign Investment in Real Property Tax Act of 1980 for “domestically controlled” REITs); Code Sec. 856(h)(3)(C) (special “unrelated business taxable income” rules for “pension-held REITs”).

⁴ Unless otherwise noted, references to the “Code” are to the Internal Revenue Code of 1986, as amended.

⁵ See Code Sec. 565 (defining the dividends-paid deduction), Code Sec. 61 (defining a corporation’s taxable income) and Code Sec. 11 (subjecting a corporation to tax on its taxable income).

⁶ Code Sec. 1(h)(11) (providing preferential tax rates for so-called “qualified dividend income”); Code Sec. 857(c)(2) (providing that REIT dividends generally do not qualify for the preferential tax rates applicable to “qualified dividend income”).

⁷ Code Sec. 243 (providing a dividends received deduction for most dividends received from domestic corporations and certain foreign corporations); Code Sec. 857(c)(1) (providing that

REIT dividends do not qualify for the dividends received deduction).

⁸ See, e.g., UNITED STATES MODEL INCOME TAX TREATY CONVENTION OF NOVEMBER 15, 2006, art. 10.4 (providing that “Subparagraph a) of paragraph 2 [providing for reduced taxation on dividends] shall not apply in the case of dividends paid by a U.S. Regulated Investment Company (RIC) or a U.S. Real Estate Investment Trust (REIT)” unless certain conditions are met).

⁹ Code Sec. 856(h)(3)(C) (treating certain dividends from “pension-held REITs” as “unrelated business taxable income”).

It is important to view these shareholder-level drawbacks alongside the entity-level benefits accorded REITs. If one were to compare taxes paid by a C corporation and taxes paid by a REIT, one would think that the use of REITs drastically lowers overall tax receipts. But if one compares the aggregate tax liability of a C corporation and its shareholders with the aggregate tax liability of a REIT and its shareholders, the picture is much different, and one realizes that the impact of the REIT regime on the fisc is far less significant than one might think. Professor Bradley Borden has ably demonstrated this point. See Bradley T. Borden, *Rethinking the Tax-Revenue Effect of REIT Taxation*, 17 FLA. TAX REV. 527, 530 (2015).

¹⁰ See Simon Johnson, *Reinvigorating the REIT’s Neutrality and Capital Formation Purposes through a Modernized Tax Integration Model*, 7 J. BUS. ENTREPRENEURSHIP & L. 61, 76 (2013–2014) (“The newly enacted REIT arrangement [of 1960] was viewed as the answer for people seeking a non-limited partnership and non-corporate business arrangement for pooled real estate investment. The REIT was heralded as the restoration of the small-investor real estate trust as a tax conduit ...”); see also Jack E. Roberts, *Public Ownership of Real Estate—Real Estate Trust Laws Provide New Impetus*, 9 UCLA L. REV. 564, 564 (1962).

¹¹ See Johnson, *supra* note 10, at 72. Johnson notes the difficulties faced by investors of modest means when investing in real estate through partnerships. For reasons discussed below, the business requirements of these partnerships—in particular, certain sharing arrangements needed to aggregate a large amount of capital from many small sources—made them particularly susceptible to being classified as corporations for tax purposes, which could result in an untenable second level of tax. Partnerships composed of smaller numbers of wealthy or institutional investors did not face comparable difficulties.

See also John P. Carroll, *Tax Policy for the Real Estate Investment Trusts*, 28 TAX L. REV. 299, 301 (noting that, after *T.A. Morrissey*, S.Ct., 36-1 USTC ¶9020, 296 US 344, 56 S.Ct. 289, “any vehicle for collective investment of funds in real estate ... would be taxed as a corporation”); see also Roberts, *supra* note 10, at 565.

¹² See Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1479 (1990–1991) (discussing the “decimating”

effect of imposing a corporate-level tax on collective investment in the mutual fund context).

¹³ This was especially true for investors of modest means in relatively low tax brackets, for whom the benefits of shareholder-level tax deferral through the use of a corporation were minimal. See Johnson, *supra* note 10, at 74–75.

¹⁴ See H. Report. No. 2020, 86th Cong., 2d Sess. (1960), at 4 (citing the need to remove tax as a consideration when investing in real estate “because of the shortage of private capital and mortgage money for individual homes, apartment houses, office buildings, factories, and hotels”).

¹⁵ *Id.*, at 3.

¹⁶ By August 1961, REITs had raised \$176 million in the public markets; by February 1963, that number was approximately \$300 million. See Cecil Kilpatrick, *Taxation of Real Estate Investment Trusts and Their Shareholders*, 39 TAXES 1042, 1044 (1961) and John MacDonald, *Real Estate Investment Trusts under the Internal Revenue Code of 1954: Proposals for Revision*, 32 GEO. WASH. L. REV. 808, 808 (1963–1964). Following a stock market downturn in 1962, however, the market for REITs stalled and did not recover until the REIT regime was made more business-friendly. See E. Norman Bailey, *Real Estate Investment Trusts: An Appraisal*, 22 FIN. ANALYSTS J. 107 (1966).

Since 1972, the growth rate of the REIT industry has dwarfed that of the S&P 500 index: a 44,759-percent increase for REITs versus 1,708-percent for the S&P 500 index. See Borden, *supra* note 9, at 534.

¹⁷ See generally “Negative Interest Rates in Europe: A Glance at Their Causes and Implications,” GLOBAL ECONOMIC PROSPECTS: A WORLD BANK GROUP FLAGSHIP REPORT (June 2015), at 13.

See also Martin A. Sullivan, *REIT Conversions: Good for Wall Street. Not Good for America*, THE TAX ANALYST BLOG (Sept. 15, 2014), available online at www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/MSUN9NXQLG?OpenDocument (“[I]n a market where investors are desperate for yield, REITs have become extremely popular.”).

¹⁸ See, e.g., Moody’s Investor Service, RATING METHODOLOGY: FINANCIAL STATEMENT ADJUSTMENTS IN THE ANALYSIS OF NON-FINANCIAL CORPORATIONS, 9–11 (June 15, 2015).

¹⁹ See, e.g., Justin Schreck, CariTuna and Ben Worthen, *Companies More Prone to Go ‘Vertical’*, WALL ST. J., Nov. 30, 2009, available online at www.wsj.com/articles/SB125954262100968855 (describing the trend over “the past half-century” away from vertical integration).

²⁰ While some of these C-to-REIT conversions and REIT spin-offs have involved non-traditional REITs, many of them have involved traditional REIT assets—land and buildings—that were subject to triple net leases.

²¹ See Peter Boos, *Runaway REIT Train? Impact of Recent IRS Rulings*, 144 TAX NOTES 1289 (Sept. 15, 2014); Sullivan, *supra* note 17; Martin Sullivan, *Economic Analysis: The Economic Inefficiency of REIT Conversions*, 144 TAX NOTES 1229 (Sept. 15, 2014); Martin A. Sullivan, *REIT Conversions: Good*

for Wall Street. Not Good for America, THE TAX ANALYST BLOG (Sept. 15, 2014), available online at www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/MSUN9NXQLG?OpenDocument; Martin Sullivan, *How Much Do Converted and Nontraditional REITs Cost the U.S. Treasury?* THE TAX ANALYST BLOG (Sept. 8, 2014), available online at www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/MSUN9NRFWQ?OpenDocument; Martin Sullivan, *The Revenue Costs of Non-Traditional REITs*, THE TAX ANALYST BLOG (Sept. 8, 2014); Anton Troianovski, *Here's a Way to Cut Business Taxes: Tech Firms Become Real Estate Trusts*, WALL ST. J., Oct. 11, 2012, available online at www.wsj.com/articles/SB10000872396390444657804578048880778578720 (describing a "growing crop of companies who are masquerading as real-estate companies" in order to capture tax benefits); see also sources cited *infra* note 24.

²² This first premise itself assumes as true a third and more fundamental premise—that the income of a corporation should generally be subject to an entity-level tax. A debate on the question of whether the corporate tax should exist at all could fill a book, and, for the reasons described in Part III *infra*, we accept the premise that it is appropriate to tax the income of corporations to the extent consistent with the policy justifications underlying the enactment of the corporate tax.

²³ See, e.g., A.D. Pruitt, *Congress Looks at REIT Tax Exemption*, WALL ST. J., Apr. 23, 2013, available online at www.wsj.com/articles/SB10001424127887323551004578441260298575162.

²⁴ See, e.g., W. Eugene Seago & Edward J. Schnee, *REIT Conversions Resurrect General Utilities*, 148 TAX NOTES, 1391, 1391 (2015) ("The ability to avoid the corporate-level tax following a C corporation's conversion to a REIT still exists even though the Tax Reform Act of 1986 contained provisions directed at repealing the *General Utilities* doctrine."); Nathaniel Popper, *Restyled as Real Estate Trusts, Varied Businesses Avoid Taxes*, N.Y. TIMES, Apr. 21, 2013, available online at www.nytimes.com/2013/04/22/business/restyled-as-real-estate-trusts-varied-businesses-avoid-taxes.html?_r=0; James Glanz, *Landlords Double as Energy Brokers*, N.Y. TIMES, May 13, 2013, available online at www.nytimes.com/2013/05/14/technology/north-jersey-data-center-industry-blurs-utility-real-estate-boundaries.html ("Real estate companies organized as investment trusts avoid corporate taxes by paying out most of their income as dividends to investors 'This is an incredible example of how tax avoidance has become a major business strategy,' said Ryan Alexander, president of Taxpayers for Common Sense, a nonpartisan budget watchdog."); Howard Gleckman, *How REIT Spinoffs Will Further Erode the Corporate Tax Base*, FORBES, July 7, 2014, available online at www.forbes.com/sites/beltway/2014/07/31/how-reit-spinoffs-will-further-erode-the-corporate-tax-base/ ("While Congress has been obsessing about tax inver-

sions, it turns out another—potentially more important—tax avoidance technique is getting increased attention").

²⁵ See also, e.g., Jack Hough, *Are REITs the Right Choice?*, BARRON'S, May 4, 2013, available online at www.barrons.com/articles/SB50001424052748703591404578453020304813236 (noting that "to some, the string of REIT conversions looks like a tax dodge," but arguing that "the tax savings for REIT conversions aren't quite as large as they appear").

²⁶ See, e.g., Borden, *supra* note 9, at 530 ("The comparison of REIT spinoffs to corporate conversions borders on misplaced hysteria.").

²⁷ See, generally, Borden, *supra* note 9.

²⁸ See Code Sec. 561 (defining the deduction for dividends paid); Code Sec. 857(b)(2)(B) (applying the deduction to REITs).

²⁹ See, e.g., Boris I. Bittker & Lawrence Lokken, *FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS* ¶ 91.10.1. Other corporations can, of course, deduct interest on indebtedness, see Code Sec. 163(a), but the tax law limits how much debt an entity can take on before any new debt starts being treated as equity (and "interest" payments thereon start being treated as non-deductible dividends). See generally, e.g., William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 507-519 (1971) (exhaustively summarizing the law on the extent to which debt can be reclassified as equity when the issuer of the debt is too "thinly capitalized"); see also Code Sec. 163(d) (limitation on the deductibility of "investment interest"); Code Sec. 163(e)(5) (limitation on the deductibility of interest on "applicable high yield discount obligations"); Code Sec. 163(j) (limitation on the deductibility of interest paid by certain highly leveraged corporations to non-taxpaying recipients); Code Sec. 163(l) (limitation on the deductibility of interest payable by a corporation in the form of equity of, or held by, the issuer or a related person); Code Sec. 279 (limitation on the deductibility of interest on certain corporate debt whose proceeds are used to acquire stock or assets of another corporation); Code Sec. 482 (permitting Treasury to reallocate items of income and deduction between related parties to reflect arm's-length pricing).

³⁰ Code Sec. 7704(a) (treating "publicly traded partnerships" as corporations).

³¹ Code Sec. 7704(c)(1)–(2) (providing an exception for publicly traded partnerships that meet a 90-percent qualifying income test); Code Sec. 7704(d)(1)(A)–(D), (d)(3)–(4) (defining qualifying income for this purpose to include most income that qualifies under the REIT rules).

³² Cf. Code Sec. 512(c)(1) ("If a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall ... include its share (whether or not distributed) of the gross

income of the partnership from such unrelated trade or business ...").

³³ Cf. Code Sec. 875(1) ("[A] nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged").

³⁴ See sources cited *supra* note 6.

³⁵ See sources cited *supra* note 7.

³⁶ In the case of foreigners in treaty jurisdictions, for example, the rate of withholding under most treaties is higher on REIT dividends than C corporation dividends. See, e.g., CONVENTION BETWEEN CANADA AND THE UNITED STATES WITH RESPECT TO TAXES ON INCOME AND CAPITAL, art.11, paras. 2, 7, Aug. 16, 1984 (providing a five-percent rate for certain C corporation dividends and a 15-percent rate for all other C corporation dividends; REIT dividends eligible only for the higher 15-percent rate and even then only if certain requirements are satisfied); CONVENTION BETWEEN THE KINGDOM OF THE NETHERLANDS AND THE UNITED STATES OF AMERICA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, art.11, paras. 2, 4, Dec. 31, 1993 (same). In the case of certain tax-exempt investors, dividends paid by a "pension-held" REIT are treated in part as UBTI. Code Sec. 856(h)(3)(C).

³⁷ Code Sec. 856(c)(4)(A).

³⁸ Code Sec. 856(c)(5)(B) (defining "real estate assets" to include both "interests in real property and interests in mortgages on real property"); Reg. §1.856-3(b)(1) (same).

³⁹ For example, a REIT with \$100 of total assets would fail the first test if it owned more than \$5 of the stock of any single issuer.

⁴⁰ For example, a REIT that owned 15 percent of the voting shares of a single issuer would fail this test, as would a REIT that owned \$15 of stock or debt securities of an issuer, where the total value of all stock and debt securities of that issuer was, say, \$100.

⁴¹ TRSs, which are discussed in more detail below, are subsidiaries. See *infra* Part II.B.3.

⁴² See H.R. Report. No. 86-2020, 1960-2 CB 731, at 3 and 6 (1960) (describing the advantages of investments in REITs as including "the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangements," and noting that the 5-percent asset test is "designed to provide diversification").

⁴³ The REIT rules do contain certain savings provisions that allow REITs to cure failures of the asset (and income) tests, including a provision for *de minimis* asset test failures, but these, in the case of asset test failures, in all cases require the REIT to fix the failure by getting itself back into compliance with the rule. The \$100 billion REIT that did not fix its \$10,000 asset test issue within the prescribed time limits would lose its REIT status.

⁴⁴ See text accompanying notes 189–191, *infra*.

⁴⁵ Code Sec. 856(c)(3).

⁴⁶ Code Sec. 856(c)(2).
⁴⁷ See generally Code Sec. 856(d)(1)(B), (2)(C), (7); Paul W. Decker et al., *Non-Customary Services Furnished by Taxable REIT Subsidiaries*, 148 TAX NOTES 413 (2015).
⁴⁸ Code Sec. 856(d)(1)(B).
⁴⁹ Code Sec. 856(d), (2)(C), (7).
⁵⁰ See *infra* Part VI.B.1.
⁵¹ Code Sec. 856(l).
⁵² Code Sec. 856(l)(3).
⁵³ For some of the more general limitations on the use of intercompany debt to generate interest deduction, see *supra* note 29. Of those limitations, Code Sec. 163(j) has specific relevance to REITs and their TRSs. See Code Sec. 163(j)(3) (defining “disqualified interest” to include certain interest payable to recipients that are not subject to U.S. tax on that interest, including specifically “any interest paid or accrued ... by a taxable REIT subsidiary ... of a real estate investment trust to such trust”); see also Code Sec. 857(b)(7) (imposing a 100-percent penalty tax on interest paid by a TRS to a REIT to the extent the interest exceeds arm’s-length rates and on other non-arm’s-length transactions between a REIT and its TRS).
⁵⁴ Code Sec. 856(c)(4)(B)(ii).
⁵⁵ This results simply from the fact that the REIT is not entitled to a dividends paid deduction for amounts that it retained rather than paying as a dividend.
⁵⁶ Code Sec. 857(a)(2).
⁵⁷ See Code Sec. 1374 (imposing this built-in gains tax on S corporation); Reg. §1.337(d)-7 (applying Code Sec. 1374 principles to RICs and REITs).
⁵⁸ See H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., Vol. II, 198-207 (1986), 1986-3 CB, Vol. 4, 198-207.
⁵⁹ See Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193 (2004); Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447 (2001); Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L. J. 889 (2006); Marjorie Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L. J. 53 (1990).
⁶⁰ See Revenue Act of 1861, Ch. 45, 12 Stat. 292 (Aug. 5, 1861), the income tax provisions of which were repealed and replaced by Revenue Act of 1862, Ch. 119, 12 Stat. 432. Tax rates were increased by Internal Revenue Act of 1864, 13 Stat. 223.
 Prior to 1862, government revenue came primarily from tariffs imposed on imported goods. See Bryan T. Camp, *A History of Tax Regulation Prior to the Administrative Procedure Act*, 63 DUKE L. J. 1673, 1685 (2014) (citing BUREAU OF THE CENSUS, U.S. DEP’T OF COMMERCE, HISTORICAL STATISTICS OF THE UNITED STATES, 1789-1945, at 295-98 ser. P 89-98 (1949) and noting that federal revenue prior to 1862 came roughly 85 percent from tariffs and 15 percent from land sales). See generally Joseph J. Thorndike, *The Almost Income Tax of 1815*, 148 TAX NOTES 624

(2015) (noting early opposition to income taxes).
⁶¹ See Camp, *supra* note 60, at 1696.
⁶² See Kornhauser, *supra* note 59, at 57.
⁶³ See *id.*; see also Gregory A. Mark, *The Personification of the Business Corporation in American Law*, 54 U. CHICAGO L. REV. 1441, 1444 (1987).
⁶⁴ See Mark, *supra* note 63, at 1457.
⁶⁵ Professor Kornhauser notes that these two features were at the center of the notion of a “corporation” in the 1909 act: “The premise of the 1909 law was the artificiality of the entity taxed. Thus, the interpretation of the law stressed those traits which evidenced that artificiality: limited liability and centralized management.” Kornhauser, *supra* note 59, at 124.
 See also Mark, *supra* note 63, at 1459 (“What differences, then, remained to distinguish a corporation from a partnership? In Taylor’s eyes [the author of the influential *A TREATISE ON THE LAW OF PRIVATE CORPORATIONS HAVING CAPITAL STOCK* (1884)], there were but two. First, in a partnership all partners were agents; in contrast, all shareholders were not agents of the corporation. Second, a shareholder could generally remove himself from any liability resulting from corporate action by selling his shares; partners retained liability for actions taken on behalf of the partnership even after they had disposed of their partnership shares. The two conditions were connected by a single vital thread: partners often managed partnerships actively while most shareholders were passive investors in corporations.”)
⁶⁶ Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167, 199 (2002) (noting that corporations could avoid “expensive and intrusive external financing sources” by “simply ... dip[ing] into retained earnings”).
⁶⁷ Initially, these monopolies were formed underneath “industrial trusts” and, later, by combining underneath a single holding corporation of the type with which we are all familiar. In the initial stage of the consolidation process, one corporation was not permitted to own stock in another corporation; as a result, if two corporations were to combine to form one business, the shareholders of each corporation had to contribute their shares to a trust in exchange for trust certificates, as trusts were allowed to own corporate shares at that time. The end result was a single trust that owned 100 percent of the shares of multiple corporations, and the trustees of the trust would vote the shares in each corporation. As the consolidation process continued, the states of New Jersey and Delaware amended their corporation statutes, to permit one corporation to own shares in another. Because the corporate form was more flexible for aggregators than the trust form, the great industrial trusts quickly morphed into corporate holding company structures.
⁶⁸ This view of the monopolies was shared by the popular and legal press alike. See, for example, this remarkable passage from the Yale Law Journal from 1912:

A mighty power has been built up in this country in recent years that seems to fairly stagger the methods of our government to maintain the equal rights of all the people. Something appears to be wrong with business interests generally, and the people are passing through a state of social unrest. The influence of financial men has become so powerful and far reaching in self-interest that doubt is expressed whether its iron grip on government and business can ever be destroyed. This mighty power has crippled or destroyed competition by placing a limitation in the field of production. It fixes the prices of finished products and raw materials and imposes its burdens upon the silent consuming public without restraint. The spirit of competition seems to have almost vanished, being superseded by extortion. In finance this mighty power of influence is unlimited. The association of men engaged in numerous channels of business regulates or controls credit. This power manipulates the volume of money by inflation or contraction required for the constant transaction of business of the entire country. Fabulous profits of business are made out of promotions and combination, by the acquisition of vast areas of the public domain and rapid monopolization of the natural resources of timber, coal and iron. Industries have been closed and business slackened in competing localities to stifle fair competition by this mighty power in illegal procedure of usurpation. Instead of living under the lofty principles of a mighty Constitution where the citizen is sovereign we are actually living under a form of government where criminal might is right.

Newton J. Baker, *Regulation of Industrial Corporations*, 4 YALE L. J. 306, 306 (1912-1913).

⁶⁹ See Kornhauser, *supra* note 59, at 57-62.

⁷⁰ As briefly discussed in Part IV.A.2(a) below, the popular shift in the view of the corporation existed alongside an analogous shift in the legal community, which developed primarily from an articulation of the legal rights of corporations. The dominant view of corporate rights prior to the late 19th century had been articulated in the *Dartmouth College v. Woodward*, SCt, 17 US 518 (1819), in which Chief Justice Marshall held that Dartmouth College derived rights by virtue of its contract with the state of New Hampshire, through its charter. Under this “artificial” view of the corporation, a corporation possessed those rights that were specially granted by the state. This view underwent various legal challenges and judicial modifications in the mid-19th century, and was dealt a major blow in the *Railroad Tax Cases*, 13 F. 722 (C.C.D. Cal. 1882), appeal dismissed as moot, *San Mateo County v. Southern Pac. R.R. Co.*, SCt, 116 US 138 (1885), in which

the Circuit Court held that private corporations were entitled to equal protection of the laws under the Fourteenth Amendment. This decision was largely predicated on the notion that corporations derived their rights from the rights of their incorporators—not state legislatures—which view was thus generally compatible with an “aggregate” (*i.e.*, partnership) view of the corporation. Commentators realized, however, that this aggregate view made it difficult to justify the corporate privilege of limited liability, which partnerships did not enjoy at the time. By contrast, under a “real” or “natural” entity view of the corporation, which developed in the late 19th century and eventually became the dominant view, a corporation derives its legal rights and privileges of its own accord, rather than from the state on the one hand or its incorporators on the other. *See, generally*, Mark, *supra* note 63; *see also* Kornhauser, *supra* note 59, at 58.

⁷¹ *See The Story of a Great Monopoly*, ATLANTIC MONTHLY, March 1881, available online at www.theatlantic.com/magazine/archive/1881/03/the-story-of-a-great-monopoly/306019 (describing efforts to regulate Standard Oil and the railroads, and noting that “the legislature of Pennsylvania was besought to pass laws to enforce the constitutional provision for equal rights on the railroads of the State, but the money of the Standard was more powerful than the petition of business men.”)

⁷² *See* Avi-Yonah, *supra* note 59, at 1215.

⁷³ *See* THE PENNSYLVANIA RAILROAD, VOLUME 1: BUILDING AN EMPIRE, 1846–1917, 459–460 (2012) (describing the U.S. House Commerce Commission’s largely ineffective subpoenas of Pennsylvania Railroad executives in 1876).

See also The Story of a Great Monopoly, supra note 71:

Just who the Standard Oil Company are, exactly what their capital is, and what are their relations to the railroads, nobody knows except in part. Their officers refused to testify before the supreme court of Pennsylvania, the late New York Railroad Investigating Committee, and a committee of Congress. The New York committee found there was nothing to be learned from them, and was compelled to confess its inability to ascertain as much as it desired to know “of this mysterious organization, whose business and transactions are of such a character that its members declined giving a history or description, lest their testimony be used to convict them of crime.”

⁷⁴ The Sherman Act of 1890, 26 Stat. 209, 15 USC §§1–7.

⁷⁵ *See* Kornhauser, *supra* note 59 (noting that, in enforcing the Sherman Act, “[t]he executive branch, first under President Roosevelt and then under Taft, accepted the view that large corporations could legitimately dominate the market”).

⁷⁶ *See* Avi-Yonah, *supra* note 59, at 1215 (noting that “[Roosevelt] was the first President to attempt to use the Sherman Antitrust Act”).

⁷⁷ *Id.*

⁷⁸ *Id.*, at 1216.

⁷⁹ Although the New York Stock Exchange had a policy beginning in 1869 that required listed companies to publish annual financial reports, the Exchange did not begin to enforce its policy until 1910 under pressure from the government. *See* Kornhauser, *supra* note 59, at 71.

Professor Kornhauser seems to adopt the view that the primary of objectives of the 1909 tax were increased publicity of corporate information through tax returns and the taxing of retained earnings, although her work focuses more on policymakers’ changing view on the nature of the corporate entity and the role of the publicity feature in helping to curb monopolistic and trade restraining behavior. *See, generally*, Kornhauser, *supra* note 59 at 69–82.

⁸⁰ 44 CONG. REC. 3965 (1909) (statement of Sen. Cummins).

⁸¹ 44 CONG. REC. 3950 (1909) (statement of Sen. Owen).

⁸² 44 CONG. REC. 4003 (1909) (statement of Sen. Root) (Emphasis added.).

⁸³ 44 CONG. REC. 4232 (1909) (statement of Sen. Cummins).

⁸⁴ *See generally* Avi-Yonah, *supra* note 59, at 1231.

⁸⁵ *See generally* Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447 (2001).

⁸⁶ *See* Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L. J. 889 (2006).

⁸⁷ *See* Roe, *supra* note 12, at 1496 (noting that, when “managers [were pushed] ... to distribute most of their profits ... [c]ompanies that needed funds were dependent on capital markets to replenish the moneys divided out. When they returned to the capital markets, bankers and securities buyers would scrutinize the managers’ results and penalize them (in the form of higher capital costs) if the results were poor.”).

⁸⁸ *See* Bank, *supra* note 86, at 944–945.

⁸⁹ Act Sec. 73 of the Revenue Act of 1894, Ch. 349, 28 Stat. 570 (Aug. 27, 1894). The corporate tax of the Revenue Act of 1894 was struck down by the Supreme Court as unconstitutional in *Pollock v. Farmers Loan & Trust Co.*, S.Ct., 157 US 429, 15 S.Ct. 673, *reh’g granted*, S.Ct., 158 US 601 (1895), on the grounds that the 1894 Act’s taxes on real and personal property were “direct taxes” which must be “apportioned among the several States,” according to Article 1 Section 2 of the Constitution.

⁹⁰ Act Sec. II G(a) of the Revenue Act of 1913, Ch. 16, 38 Stat. 172.

⁹¹ *See* Bank, *supra* note 86, at 917.

⁹² Act Sec. II A(1) and (2) of the Revenue Act of 1913, Ch. 16, 38 Stat. 172.

⁹³ *Id.*

⁹⁴ Professor Bank notes that a corporation could be taxed on its undistributed earnings beginning with the 1913 Act, but that this tax only applied if earnings were undistributed with the intent to avoid a shareholder-level surtax. The tax was rarely imposed in practice due to difficulties surrounding

its subjective nature. A tax on undistributed earnings regardless of intent was not imposed until 1936. *See* Bank, *supra* note 66, at 170. *See also* Bank, *supra* note 86, at 920 (“Given the relatively small spread between the corporate rate and the top surtax rate, this provision did not appear to be worth the political expense that would come from eliminating deferral.”).

⁹⁵ For example, in 1913, the corporate rate was one percent while the top individual rate was seven percent; by 1917, the corporate rate had risen to six percent but the top individual combined rate had been raised to 67 percent to fund the war effort. Act Sec. I(2) of War Revenue Act of 1917, 40 Stat. 300.

⁹⁶ *See* Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 WASH. & LEE L. REV. 1159, 1187–90 (2004).

Bank notes that, at the end of the 19th century, “the notion that corporations would defer dividends to shield them from taxation would have been considered quite foreign.” *See* Steven A. Bank, *Historical Perspective on the Corporate Interest Deduction*, 18 CHAPMAN L. REV. 29, 33 (2014–2015). *See also* Steven A. Bank, *From Sword to Shield: The Transformation of the Corporate Income Tax, 1861 to Present*, at 51, fig. 2 (2010) (illustrating that the dividend payout for public corporations between 1871 and 1895 was approximately 80 percent).

⁹⁷ *See* Bank, *supra* note 86, at 920–922.

⁹⁸ *See* Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463, 466 (2003).

⁹⁹ *See generally*, Bank, *supra* note 96, at 1189–1200.

¹⁰⁰ Code Secs. 1291–1297.

¹⁰¹ *See generally*, Bank, *supra* note 86, at 931.

¹⁰² *See also* Boris I. Bittker, Martin J. McMahon & James J. Freeland, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 2.05 (Emphasis added), noting that the disparate tax treatments of corporations and partnerships could be ameliorated through a partially integrated corporate tax, but that corporate managers might have reason to oppose such integration:

Under this approach, a corporate-level tax would be imposed, but the double taxation of dividends would be eliminated either by allowing a dividends-paid deduction to the corporation or by allowing a credit to the shareholder for tax paid by the corporation. *Corporations do not seem to be clamoring for partial integration, however, perhaps because officers of public corporations like to retain earnings in their corporations, and the current tax system gives them a good reason to do so.*

¹⁰³ Reg. §301.7701-1 to §301.7701-7 (1996), T.D. 8697, IRB 1997-2, 11.

¹⁰⁴ *See* William B. Dockser, *Real Estate Investment Trusts: An Old Business Form Revitalized*, 17 U. MIAMI L. REV. 115, 116 (“The business trust, as we now know it, had its origins in the middle eighteenth hundreds, when Massachusetts law made it difficult to secure a charter for the

development of real estate without an act of the legislature (General Court).” See also Su Han Chan, John Erickson, and Ko Wang, *REAL ESTATE INVESTMENT TRUSTS: STRUCTURE, PERFORMANCE, AND INVESTMENT OPPORTUNITIES* 14 (2002).

Some early real estate investment vehicles were in fact organized as corporations, presumably pursuant to special legislative grants. See Lawrence M. Channing, *Federal Taxation of the Income of Real Estate Investment Companies*, 36 *TAXES* 502, 505 (1958).

¹⁰⁵ Limited liability partnerships did not exist in the United States until Texas passed the Registered Limited Liability Partnership Act in 1991. See *Tex. Civ. STAT. ANN.* art. 1528n, §11.07, art. 6132b, §15, although limited liability companies subject to tax as partnerships emerged in the late 1970s. See text accompanying *infra* note 177.

¹⁰⁶ *Attorney General v. Proprietors of the Meeting-house*, 69 *Mass.* 1 (1854), writ of error dismissed, 66 *US* 262 (1861).

¹⁰⁷ See H. Cecil Kilpatrick, *Real Estate Investment Trusts*, 3 *TAX REVISION COMPENDIUM OF PAPERS ON THE TAX BASE* 1697, 1698; Chan et al, *supra*, note 104, at 15; Dudley J. Godfrey & Joseph M. Bernstein, *The Real Estate Investment—Past, Present and Future*, 1962 *Wis. L. Rev.* 637, 638 (1962); Kilpatrick, *supra* note 16, at 1044; see also Channing, *supra* note 104, at 502 (“Early in the century they [i.e., REITs] did yeoman service by providing capital for development of the West.”).

¹⁰⁸ See John Morley, *Collective Branding and the Origins of Investment Fund Regulation*, 6 *VA. L. & Bus. Rev.* 341, 348 (2011–2012).

¹⁰⁹ See Avi-Yonah, *supra* note 59, at 1227.

¹¹⁰ See Morley, *supra* note 108, at 347.

¹¹¹ See *supra* note 89.

¹¹² See generally Patrick E. Hobbs, *Entity Classification: The One Hundred Year Debate*, 44 *CATH. U. L. Rev.* 437, esp. 447–452 (1995). Hobbs quotes a remarkable exchange between Senators Aldrich (Rhode Island), Allison (Iowa), Hoar (Massachusetts), and Vest (Kentucky) that illustrates the difficulty the Senator had in defining the scope of a “corporate” tax. Senator Hoar noted that the proposed language seemed to apply even to partnerships:

Mr. ALDRICH. I should be glad to have the Senator from Missouri state whether the interpretation given to this bill by the Senator from Massachusetts in his opinion is a correct one, because if the word “association” here includes partnerships, as the Senator from Massachusetts stated, as I understand—

Mr. HOAR. I did not say that.

Mr. ALDRICH. That is what I understood the Senator to say.

Mr. HOAR. I said “companies.”

Mr. ALLISON. I do not understand, and I should be glad to have the Senator from Missouri state, whether he understands that this section and the subsequent sections regulating this subject are intended to deal with anything but associated corporations?

Mr. VEST. That is the meaning of it. I have not had any doubt about it. If I had intended to use the word “partnerships,” I should have said “partnerships.” For instance, take *building and loan associations*. That is the way they style themselves. They are not called “companies;” they are not called “corporations” eo nomine, but they are called “associations.” Two or more individuals associate themselves, and we have a chapter in the Revised Statutes of Missouri which provides for these associations. They are quasi corporations.

Mr. HALE. That is not a private business partnership.

Mr. VEST. No; that is not a partnership.

Mr. HOAR ... I should like to ask my friend from Missouri, who is a good lawyer and does not want to draw a bill and be responsible for an act that has doubt in its meaning, whether it is not better to make his meaning clear, and whether it is not, to say the least, a doubtful question whether the clause “corporations, companies, or associations doing business for profit in the United States, no matter how created or organized,” does not include partnerships? I say on my responsibility as a lawyer that I think it does. I should give that opinion as at present advised to a client or to an officer of the Government. I can not conceive a more apt description of a partnership than “companies or associations doing business for profit.” *If a partnership is not a company or association of men doing business for profit, what in the world is it, however established or organized.*

26 *CONG. REC.* 6833–35 (1894) (Emphasis added).

¹¹³ *Id.*

¹¹⁴ 26 *CONG. REC.* 6880 (1894) (statement of Sen. Chandler).

¹¹⁵ *Pollock v. Farmers Loan & Trust Co.*, *SCt*, 157 *US* 429, 15 *SCt* 673, *reh'g granted*, *SCt*, 158 *US* 601 (1895).

¹¹⁶ Act Sec. 38 of the Tariff Act of 1909, Ch. 6, 36 *Stat.* 11, 112–113.

¹¹⁷ See Kornhauser, *supra* note 59, at 102–103.

¹¹⁸ *Id.*, at 60–61.

¹¹⁹ *Id.*, at 61.

¹²⁰ See generally Kornhauser, *supra* note 59 and Mark, *supra* note 63.

¹²¹ Act Sec. 38 of the Tariff Act of 1909, Ch. 6, 36 *Stat.* 11, 112–118.

¹²² *Eliot v. Freeman*, *SCt*, 220 *US* 178 (1911).

¹²³ In declining to extend the corporate tax to the real estate investment trust, the Court held that—Entertaining the view that it was the intention of Congress to embrace within the corporation tax statute only such corporations and joint stock associations as are organized under some statute or derive from that source some quality, or benefit not existing at the common law, we are of opinion that the real estate trusts ... are not within the terms of the

[Corporate Excise Tax].

Id., at 187. Although this rationale for the corporate tax was entertained by President Taft and certain congressmen in the lead up to the 1909 Act (though opposed by many others), it was generally viewed as inadequate on the grounds that most statutory benefits of the corporate form derived from state (rather than federal) law. See Avi-Yonah, *supra* note 59, at 19–20.

¹²⁴ Revenue Act of 1913, Ch. 16, 38 *Stat.* 172.

¹²⁵ Revenue Act of 1916, Ch. 463, 39 *Stat.* 756.

¹²⁶ War Revenue Act of 1917, 40 *Stat.* 300.

¹²⁷ Revenue Act of 1918, 40 *Stat.* 1057.

¹²⁸ Revenue Act of 1921, Ch. 136, 42 *Stat.* 227.

¹²⁹ Act Sec. II G(a) of the Revenue Act of 1913, Ch. 16, 38 *Stat.* 172 (Emphasis added.).

¹³⁰ *Crocker v. Malley*, *SCt*, 1 *USTC* ¶24, 249 *US* 223, 39 *SCt* 270 (1919).

¹³¹ *Crocker v. Malley*, *SCt*, 1 *USTC* ¶24, 249 *US* at 233 (1919).

¹³² *Crocker v. Malley*, *SCt*, 1 *USTC* ¶24, 249 *US* at 234 (1919).

¹³³ *Crocker v. Malley*, *SCt*, 1 *USTC* ¶24, 249 *US* at 232 (1919) (Emphasis added.).

¹³⁴ *Crocker v. Malley*, *SCt*, 1 *USTC* ¶24, 249 *US* at 234 (1919) (Emphasis added.).

¹³⁵ As a practical matter, this argument from congressional intent was not an explicit criterion for taxation as a trust following *Crocker*; instead, both the courts and the IRS adopted the more easily administrable “control” test. But the language quoted above indicates that the Court viewed the lack of control of the trust over its subsidiary corporations as an indication that such trusts were outside the scope of the corporate tax as intended by Congress. Seen in this light, the technical control test in *Crocker* can be seen as a kind of proxy for the Court’s policy-based considerations. In any case, those considerations clearly indicate that the Court understood, correctly in our view, that one of the rationales underlying the corporate tax was to, in the language of the opinion, discourage certain corporate combinations.

¹³⁶ Reg. 45, Article 1502 under the Revenue Act of 1918 (Emphasis added.).

¹³⁷ See Reg. 62, Article 1504 under the Revenue Act of 1921:

Association distinguished from trust. Where trustees hold real estate subject to a lease and collect the rents, doing no business other than distributing the income less taxes and similar expenses to the holders of their receipt certificates, who have no control except the right of filling a vacancy among the trustees and of consenting to a modification of the terms of the trust, no association exists and the cestuis que trust are liable to tax as beneficiaries of a trust the income of which is to be distributed periodically, whether or not at regular intervals. But in such a trust if the trustees pursuant to the terms thereof have a right to hold the income for future distribution, the net income is taxed to the trustees instead

of the beneficiaries If, however, the cestuis que trust have a voice in the conduct of the business of the trust, whether through the right periodically to elect trustees or otherwise, the trust is an association within the meaning of the statute.

¹³⁸ See, e.g., *Chicago Title & Trust Co. v. Smietanka*, DC-IL, 275 Fed. 60, 1921 CT 080 (1921) (trust holding stock was an association where the beneficiaries had the power to instruct the trustees of the trust how to vote with respect to the stock); *Weeks v. Sibley*, DC-TX, 1 ustrc ¶37, 269 Fed. 155 (1920) (citing *Crocker*, and holding a trust was not an association where beneficiaries lacked control of the trust); see also Henry Rottschaefer, *Massachusetts Trust Under Federal Tax Law*, 25 COLUM. L. REV. 305, 309 (1925) (“these principles [of *Crocker*] have been followed by the lower federal courts in every subsequent income tax case, even when the trust involved was a so-called operating trust.”); see generally Taubman, *infra* note 146, at 108.

¹³⁹ *Hecht*, SCT, 265 US, at 147 (Emphasis added.).

¹⁴⁰ See Rottschaefer, *supra* note 138, at 309 (“The principles enunciated by the Supreme Court in its opinion in the *Hecht* case constitute the first definite pronouncement that the nature of its activities is a decisive factor in fixing the legal position of a business trust for federal taxation, or for any other purpose.”).

¹⁴¹ See *infra* Part IV.A.2(e).

¹⁴² Reg. 69, Article 1504 under the Revenue Act of 1924.

¹⁴³ Reg. 74, Article 1314 under the Revenue Act of 1928.

¹⁴⁴ Reg. 77, Article 1314 under the Revenue Act of 1932.

¹⁴⁵ Reg. 86, Act Sec. 801-2 of the Revenue Act of 1934.

¹⁴⁶ See *J. Blum*, 25 BTA 119, Dec. 7371 (1932); *C. H. McCormick*, 26 BTA. 1172, Dec. 7763 (1932), *aff'd*, CA-7, 37-1 ustrc ¶19187, 68 F2d 653; *Prior & Lockhart Development Co.*, 26 BTA. 1054, Dec. 7748, *aff'd*, CA-10, 70 F2d 154; *Brouillard*, CA-10, 70 F2d 154 (1934), *cert. denied*, SCT, 293 US 574, 55 Sct 85 (1934). See also Joseph Taubman, *The Land Trust Taxable as Association*, 8 TAX L. REV. 103, 109 (noting that “[s]ince the Supreme Court [in *Hecht*] had not spelled out what constituted corporate resemblance, the lower courts adopted confusing and contradictory tests that were difficult to apply.”).

¹⁴⁷ Lloyd M. Smith, *Associations Classified as Corporations Under the Internal Revenue Code*, 34 Cal. L. Rev. 461, 462 (1946) (citing *Burk-Waggoner Ass'n v. Hopkins*, DC-TX, 296 Fed. 492, 498 (1924), *aff'd* SCT, 1 ustrc ¶143, 269 US 110, 46 Sct 48 (1925); *Page v. McLaughlin*, DC-PA, 7 FSupp 75, 77 (1933)).

¹⁴⁸ *Id.*, citing Dale H. Flagg, *Associations Taxable as Corporations*, 13 TAXES 589 (1935).

¹⁴⁹ *T.A. Morrissey*, SCT, 36-1 ustrc ¶19020, 296 US 344, 56 Sct 289.

¹⁵⁰ Reg. §301.7701-2(a)(1) (prior to T.D. 8697, 1997-2 IRB) (providing in part that “[a]n

organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust. See *Morrissey et al. v Commissioner* (1935) 296 US 344.”).

¹⁵¹ *Morrissey*, SCT, 36-1 ustrc ¶19020, 296 US at 359. See Thomas M. Hayes, *Checkmate, the Treasury Finally Surrenders: The Check-the-Box Treasury Regulations and Their Effect on Entity Classification*, 54 WASH. & LEE L. REV. 1147, 1152 (1997).

¹⁵² *Morrissey*, SCT, 36-1 ustrc ¶19020, 296 US 362 (1935).

¹⁵³ *Morrissey*, SCT, 36-1 ustrc ¶19020, 296 US 365 (1935).

¹⁵⁴ *Morrissey*, SCT, 36-1 ustrc ¶19020, 296 US 369 (1935).

¹⁵⁵ See Reg. 86, Article 801-3, providing in relevant part:

If a trust is an undertaking or arrangement conducted for income or profit, the capital or property of the trust being supplied by the beneficiaries, and if the trustees or other designated persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the beneficiaries are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classified by the Act as a corporation.

¹⁵⁶ See Hobbs, *supra* note 112, at 478 (“The decision [provided] two significant contributions to the entity classification debate. First, after *Morrissey* the entity-classification methodology forever would be known as the ‘resemblance test.’ Second, and perhaps more significantly, the *Morrissey* Court noticed that Congress delegated to the Treasury Department the role of determining the nature of a corporation for federal tax purposes.”)

¹⁵⁷ See *Morrissey*, SCT, 36-1 ustrc ¶19020, 296 US at 354–355 (noting that, because “the [Act] merely provided that the term ‘corporation’ should include ‘associations,’ without further definition, the Treasury Department was authorized to supply rules for the enforcement of the Act within the permissible bounds of administrative construction. Nor can this authority be deemed to be so restricted that the regulations, once issued, could not later be clarified or enlarged so as to meet administrative exigencies or conform to judicial decision.”); see also Hobbs, *supra* note 112, at 478.

¹⁵⁸ See text accompanying notes 65, 117 and 118.

¹⁵⁹ See *supra* Part III.B.

¹⁶⁰ See *supra* Part III.B.

¹⁶¹ See, e.g., Oliver Hart, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE, 95–120 (1995) (cited in Avi-Yonah, *supra* note 60, at 233).

¹⁶² *O.L. Pelton*, CA-7, 36-1 ustrc ¶19195, 82 F2d 473.

¹⁶³ *A.R. Kintner*, CA-9, 54-2 ustrc ¶9626, 216 F2d 418.

¹⁶⁴ Existing Treasury Regulations gave the IRS latitude to determine whether an unincorporated

association was taxable regardless of that association’s legal form. The IRS argued that, because doctors were prohibited by state law from organizing as corporations, Dr. Kintner’s practice was not an association for tax purposes. The court rejected this argument, noting that the IRS had long held that an entity’s classification under state law was irrelevant to its treatment under federal tax law. See *Kintner*, CA-9, 54-2 ustrc ¶9626, 216 F2d at 423 (“The Government’s contention here goes counter ... to the policy of the Internal Revenue Department, which, at all times, declines to be bound by State law.”).

See also Hobbs, *supra* note 112, at 484. (“The government’s reliance on local law was ironic because, as Judge Yankwich writing for the three-judge panel noted, the Service always refuses to be ‘bound by State law.’ The court also declined to follow the government’s reliance on state grounds because the government’s regulations themselves undermined the government’s argument.”)

¹⁶⁵ Rev. Rul. 56-23, 1956-1 CB 598.

¹⁶⁶ Rev. Rul. 57-546, 1957-2 CB 886.

¹⁶⁷ Reg. §301.7701-1 to §301.7701-11 (1960); T.D. 6503, 1960-2 CB 409.

¹⁶⁸ See former Reg. §301.7701-2(b)(3), -2(c)(4), -2(d)(1) (providing that partnerships whose charters conform to the Uniform Partnership Act will generally lack continuity of life, centralization of management, and limited liability).

¹⁶⁹ See Hobbs, *supra* note 112, at 489, citing ALA. CODE §§10-4-380 to -406 (1975) (legislation approved in 1961); COLO. REV. STAT. §12-36-134 (1969); FLA. STAT. ANN. §§621.01 to .15 (1969); IDAHO CODE §§30-1301 to -1315 (1963); MASS. GEN. LAWS ANN. ch. 156A, §§1-17 (1965); MINN. STAT. ANN. §§319.01 to .961 (1963); MO. ANN. STAT. §§356.010 to .261 (1963); N.D. CENT. CODE ANN. §§10-31-01 to -14 (1963); OKLA. STAT. ANN. tit. 18, §§801 to 819 (1963); UTAH CODE ANN. §§16-11-1 to -15 (1963).

¹⁷⁰ See Proposed Reg. §§301.7701-1(d), 301.7701-2(g), (h), 28 FR 13,750, 13,751 (1963) (approved by T.D. 6797, 1965-1 CB 553).

¹⁷¹ It was widely understood at the time that interests in medical practices were almost never freely transferable. Thus, any medical services corporation would lack the corporate characteristics of free transferability, centralized management and limited liability, making it impossible for the corporation to qualify as a corporation for tax purposes.

¹⁷² See, e.g., *H.A. Kurzner*, CA-5, 69-1 ustrc ¶19428, 413 F2d 97, 106 n.43. See Rev. Rul. 70-101, 1970-1 CB 278 for list of court cases invalidating the 1965 proposed regulations.

¹⁷³ Rev. Rul. 70-101, 1970-1 CB 278.

¹⁷⁴ See Hobbs, *supra* note 112, at 498–500.

¹⁷⁵ *P.G. Larson*, 66 TC 159, Dec. 33,793 (1976), *acq.* 1979-2 CB 1, 2d *acq.* 1979-2 CB 2.

¹⁷⁶ See Hobbs, *supra* note 112, at 500; see also Note, *Tax Classification of Limited Partnerships: The IRS Bombards the Tax Shelters*, 52 N.Y.U. L. REV. 408, 410-11 (1977).

The *Larson*–HUD episode revealed yet another sign that we were experiencing a

debacle—when one executive branch agency, having been stymied by its own regulations, attempts to amend those regulations, only to have the amendments scuttled by another executive branch agency in less than 48 hours.

¹⁷⁷ Wyoming Limited Liability Company Act, Wyo. STAT. §§17-15-101 to -136 (1977).

¹⁷⁸ Rev. Rul. 88-76, 1988-2 CB 360.

¹⁷⁹ Reg. §§301.7701-1 to -7 (1996); T.D. 8697, IRB 1997-2, 11.

¹⁸⁰ See, e.g., Tom Nicholas and Anna Scherbina, *Real Estate Prices During the Roaring Twenties and the Great Depression*, UC DAVIS GRAD. Sch. of MGMT. RESEARCH PAPER No. 18-09 (noting that Manhattan real estate prices fell from their 1929 peak by 67 percent during the Great Depression).

¹⁸¹ See Theodore Lynn, *Real Estate Investment Trusts: Problems and Prospects*, 31 *FORDHAM L. REV.* 73, 78 (1962–1963) (noting that the REIT industry may not have lobbied for passthrough treatment in 1936 because of “lack of need due to the absence of taxable incomes,” and quoting a letter from Representative Keogh, who had sponsored the REIT legislation, stating, “I am informed that the practical reason . . . was that these trusts were generally operating at losses, due to defaults by tenants, and were not feeling the income tax pinch at the time.”).

¹⁸² See Act Secs. 27 (providing for a dividends paid deduction) and 48(e) (defining a “mutual investment company”) of the Revenue Act of 1936 (P.L. 740), 49 Stat. 1648 (1936). See in particular Section 48(e)(2), which provided that, “corporation shall not be considered as a mutual investment company [and thus not as entitled to the dividends paid deduction] if, subsequent to a date thirty days after the date of the enactment of this Act, at any time during the taxable year—
(A) More than 5 per centum of the gross assets of the corporation, taken at cost, was invested in stock or securities, or both, of any one corporation, government, or political subdivision thereof, but this limitation shall not apply to investments in obligations of the United States or in obligations of any corporation organized under general Act of Congress if such corporation is an instrumentality of the United States; or
(B) It owned more than 10 per centum of the outstanding stock or securities, or both, of any one corporation; or
(C) It had any outstanding bonds or indebtedness in excess of 10 per centum of its gross assets taken at cost; or
(D) It fails to comply with any rule or regulation prescribed by the Commissioner, with the approval of the Secretary, for the purpose of ascertaining the actual ownership of its outstanding stock.”

¹⁸³ The similarity of the 1936 Act’s description of RICs and their pre-*Morrissey* operating model likely owes, in part, to the fact that diversified investment funds were intimately involved in the drafting of the relevant provisions of the Act. Paul Cabot, for example, was the president of the State Street Investment Company, a Mas-

sachusetts investment company that heavily lobbied Senator David Walsh of Massachusetts in connection with the Act. Years later, Mr. Cabot would say, “God, I practically wrote the law.” See INTERVIEW BY R.J. TOSIELLO WITH PAUL C. CABOT (Oct. 9, 1978), available in Records Relating to Investment Banking, 1870-1971 (inclusive) (on file with Harvard Business School Baker Library Historical Collections, Harvard University), cited by Morley, *supra* note 108, at 358.

¹⁸⁴ See *supra* notes 152–154.

¹⁸⁵ REVENUE ACT OF 1936: CONFIDENTIAL HEARINGS ON H.R. 12395 BEFORE THE SENATE COMM. ON FINANCE, 74th Cong., 2d Sess., pt. 10, at 61.

¹⁸⁶ See note 182. The 1936 RIC Legislation does not seem to have been enacted primarily to prevent the double taxation of corporate dividends. See John C. Dawson, Jr., *The Real Estate Investment Trust*, 40 *TEX. L. REV.* 886, 887 (1961–1962) (citing the legislative history as “indicat[ing] that a desire to eliminate a double tax effect had not been an important consideration in allowing the regulated investment company special tax treatment. The primary consideration was affording the small investors a chance to pool their resources and at the same time obtain the tax benefits available to large investors.”).

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ Beginning in 1935, one corporation was not allowed to deduct the amount of dividends received from another corporation. See The Revenue Act of 1935, 49 Stat. 1014 (Aug. 30, 1935). This intentional double taxation of corporate income was designed to punish the multi-tiered monopolies that resulted from the wave of consolidation of the late 19th and early 20th centuries. See Morley, *supra* note 108, at 359 (noting that when “President Roosevelt proposed for the first time a requirement that corporations must pay tax on ordinary income in the form of dividends received from other corporations . . . [he] said unapologetically that part of the inter-corporate dividend tax’s purpose was to discourage large holding company structures.”) (citing *The President’s Message to Congress Urging Increased Taxes on Wealth*, *WASH. POST*, June 20, 1935, at 1.) If RICs were allowed to buy up a significant number of corporations in a particular industry, then RICs would be able to engage in the monopolistic practices that Congress was trying to prevent without having to pay an extra level of tax on corporate dividend income.

¹⁹⁰ Arthur Kent, Acting Chief Counsel to the Bureau of Internal Revenue, noted in a hearing preceding the enactment of the 1936 Act that one of its aims was “to prevent an investment trust or investment corporation being set up to obtain control of some corporation and to manipulate its affairs.” See REVENUE ACT OF 1936: CONFIDENTIAL HEARINGS ON H.R. 12395 BEFORE THE SENATE COMM. ON FINANCE, 74th Cong., 2d Sess., pt. 11, at 11.

¹⁹¹ 49 Stat. 1648, §14(b).

¹⁹² See Bank, *supra* note 86, at 931.

¹⁹³ A version of the bill passed the House that extended the dividends paid deduction to *all* corporations, but the bill failed to pass the Senate. See Morley, *supra* note 108, at 360. The deduction was then reinserted but only applied to investment trusts; it was during the hearings discussing this reinsertion that Acting Chief Counsel Kent asserted that Congress had never intended to subject collective investment to the corporate tax. See text accompanying *supra* notes 183–185.

¹⁹⁴ See John H. Gardiner, *Real Estate Investment Trusts*, 100 *TR. & EST.* 614, 614 (1961) (“In the depression years, such a corporate tax [imposed on REITs after *Morrissey*] was of minor consequence, but in the years following World War II, the burden was so oppressive that it became impossible to interest investors in purchasing new share of real estate trusts while the Federal government was taking away up to fifty-two per cent of the net income in taxes.”).

See also Bernstein and Godfrey, *supra* note 107, at 642–643.

¹⁹⁵ See sources cited *supra* note 10 and 11.

¹⁹⁶ See Johnson, *supra* note 10, at 72–73.

¹⁹⁷ See sources cited at *supra* note 194. See also Mitchell N. Baron, *The Tax Status of Real Estate Investment Trusts: A Reassessment*, 9 *COLUM. J. L. & SOC. PROBS.* 166, 180–181 (1972–1973) (describing the factors contributing to scarcity of capital for real estate development).

¹⁹⁸ See also Bernstein and Godfrey, *supra* note 107, at 643–644.

¹⁹⁹ See Roe, *supra* note 12, at 1478–1480 (“Tax relief for mutual funds had a fairness-based justification. The wealthy could get the benefits of professional management by hiring their own trustee to manage their portfolio. The middle-class could only get this professional help through a mutual fund. But after *Morrissey* . . . getting that professional help was inordinately expensive. Tax doctrine was reconciled with the goal of giving the middle-class collective access to professional investment management by returning to the view that picking a fragmented portfolio was not really a business after all.”).

²⁰⁰ See H.R. Report No. 86-2020, 1960-2 CB 731, 821, 1960 (stating that granting real estate collective investment tax parity with collective investment in securities “is particularly important at the present time because of the shortage of private capital and mortgage money for individual homes, apartment houses, office buildings, factories, and hotels. At the present time the financing of these real estate equities and mortgages is dependent largely on Government-guaranteed money, and investments by special groups, such as insurance companies and pension trusts.”).

²⁰¹ See Dockser, *supra* note 104, at 123 (“the Committee [drafting the REIT legislation] is careful to use as its model of an acceptable real estate investment trust, the Massachusetts (or business trust as it had come to be used. The Committee states that, ‘the general requirements include provisions that the trusts be managed by trust-

ees, have transferable shares or certificates of beneficial interest, and that they be a type of organization which would be taxed as an ordinary domestic corporation in the absence of the provisions of the bill.' It is clear from this statement that the Committee had the Massachusetts or business trust in mind when passing the Act.”).

²⁰² See *supra* Part IV.A.3.

²⁰³ See Code Sec. 856(d)(3) (1960). Although providing services would not disqualify the REIT *per se*, any income attributable to the provision of any services was treated as nonqualifying income for purposes of the income tests. *Id.*

²⁰⁴ For example, a 1960 REIT that owned any inventory property would lose its REIT status—even if it did not recognize gain from sale of the property or, indeed, even if it did not sell the property at all. Code Sec. 856(a)(4) (1960). Contrast that treatment with today’s REIT rules on inventory, which impose a 100-percent penalty tax on inventory gain but otherwise are not relevant to an entity’s qualification as a REIT. See Code Sec. 857(b)(6). Similarly, in addition to the 1960 versions of the current 75-percent and 95-percent income tests, the 1960 REIT Legislation also contained a 30-percent income test, which prevented a REIT from deriving more than 30 percent of its income from either (i) the sale of securities held for six months or less or (ii) the sale of real estate held for four years or less (even though, in either case, that gain may have qualified for one or both of the other income tests). Code Sec. 856(c)(4) (1960).

²⁰⁵ For a helpful summary of the developments specifically in the area of tenant services, see Decker *et al.*, *supra* note 47, at 416–423. For other discussions of the modernizing amendments to the REIT rules, see generally, *e.g.*, James S. Halpern, *Real Estate Investment Trusts and the Tax Reform Act of 1976*, 31 TAX LAW. 329 (1978) (discussing the amendments contained in the Tax Reform Act of 1986); Tony M. Edwards, NAREIT, *REITs Modernized* (1999), available online at www.reit.com/sites/default/files/media/Portals/0/Files/Nareit/htdocs/policy/government/RMA-2.pdf (summarizing the REIT Modernization Act of 1999); Tony M. Edwards & Dara F. Bernstein, NAREIT, *REITs Improved*, available online at www.reit.com/sites/default/files/media/Portals/0/Files/Nareit/htdocs/policy/government/BNAArticlefinal%201-03-05.pdf (summarizing the REIT amendments passed as part of the American Jobs Creation Act of 2004); Tony M. Edwards & Dara F. Bernstein, NAREIT, *REITs Empowered*, 24 TAX MANAGEMENT REAL EST. J. 7 (2008), available online at www.reit.com/sites/default/files/media/Portals/0/PDF/REITSEMPOWERED.pdf (summarizing the REIT Investment Diversification and Empowerment Act of 2007).

²⁰⁶ See, *e.g.*, S. Rep. No. 94-938, at 473-474 (June 10, 1976) (noting that the restrictions in the 1960 REIT Legislation did “not follow normal commercial practice”); see also Joint Committee on Taxation, General Explanation of the

Tax Reform Act of 1986, at 391 (“The Congress believed that [the] requirements of [pre-1986] law ... may be overly restrictive and should be liberalized”); 145 CONG. REC. S5377 (daily ed. May 14, 1999) (statement of Sen. Mack) (“As a result [of the pre-1999 rules on REIT services], REITs increasingly have been unable to compete with privately-held partnerships and other more exclusive forms of ownership Certainly, this is not consistent with what Congress intended when it created REITs, and when it modified the REIT rules over the years.”).

²⁰⁷ To ensure that the contractor was truly “independent” of the REIT, the 1960 REIT Legislation defined an independent contractor so as to exclude entities that directly or indirectly owned, or whose owners directly or indirectly owned, a significant stake in the REIT, based on complex attribution rules that had the potential to disqualify many entities that a layman might consider obviously independent. See Code Sec. 856(d)(3) (1960). This basic definition has survived to this day. See Code Sec. 856(d)(3), (5).

²⁰⁸ See Decker *et al.*, *supra* note 47, at 416–417. The statute itself only provided that a REIT could not furnish services other than through an independent contractor—without drawing a distinction between customary and non-customary services or between separate and bundled charges—but early regulations issued in 1962 made these distinctions relevant. See *id.*

²⁰⁹ Even today, these requirements continue to apply where an independent contractor is used to provide noncustomary services. See Reg. §1.856-4(b)(5).

²¹⁰ See Decker *et al.*, *supra* note 47, at 417, n. 30 (“A Goldman Sachs report from 1996 stated that only 10 REITs of any real size existed during the 1960s but that those REITs had ‘miniscule’ portfolios of real property when compared with other property owners.”) (citing Ralph L. Block, INVESTING IN REITs: Real Estate Investment Trusts 110-111 (2006)).

²¹¹ Act Sec. 1604(b) of the Tax Reform Act of 1976 (P.L. 94-455), 90 Stat. 1520, 1749 (1976); Code Sec. 856(d)(1)(B) (providing that the term “rents from real property” includes “charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated.”).

²¹² Act Sec. 1604(b) of the Tax Reform Act of 1976 (P.L. 94-455), 90 Stat. 1520, 1749 (1976); Code Sec. 856(d)(2)(C) (1976).

²¹³ See STAFF OF JOINT COMMITTEE ON TAXATION, 99TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 391 (COMM. PRINT 1987) (stating that some REIT restrictions pre-1986 “may [have been] overly restrictive and should be liberalized consistent with maintaining the essential passivity of the REIT.”); see also David M. Einhorn, *Unintended Advantage: Equity REITs vs. Taxable Real Estate Companies*, 51 TAX LAW. 203, 210–211 (1997–1998).

²¹⁴ As noted above, the only limitation on the operation of a TRS is that it cannot “operate or

manage” a healthcare or lodging facility. See *supra* note 52 and accompanying text.

²¹⁵ See note 1 and accompanying text.

²¹⁶ See Note, *The Real Estate Investment Trust—Past, Present, and Future*, 23 U. PITT. L. REV. 779, 779 (1962) (“At the time [he vetoed the bill], President Eisenhower, following the advice of the Treasury Department, said: ‘Though intended to be applicable only to a small number of trusts, it could, and might well become, available to many real estate companies which were originally organized and have always carried on their activities as fully taxable corporations.’” (quoting Baldinger, *Real Estate Investment Trusts*, 27 J.B.A. D.C. 584 (1960)).

²¹⁷ Theodore S. Lynn, Harry F. Goldberg and Robert H. Steinfeld, REAL ESTATE INVESTMENT TRUSTS at 1022 (1987), cited by Note, *Managing the Real-Estate Investment Trust: An Alternative to the Independent Contractor Requirements*, 107 HARV. L. REV. 1117, 1126 (1993–1994).

²¹⁸ See Theodore K. Quinn, UNCONSCIOUS PUBLIC ENEMIES, 121–122 (1962) (noting that “testimony developed during hearings held by the Subcommittee on Anti-trust and Monopoly of the Senate Judiciary Committee shows that more money flows through [GM’s] coffers than is ever seen by the combined treasuries of forty states of the union. In this sense, GM is several times richer than the State of New York.”).

²¹⁹ During his confirmation hearings in 1953, Wilson was asked by the Senate confirmation panel how he would address conflicts between his role as Secretary of Defense and his status as a large shareholder of GM, and famously replied that a conflict ought never exist, because “for years I thought that what was good for our country was good for GM, and vice-versa.” See *Excerpts From Two Wilson Hearing Before Senate Committees on Defense Appointment*, N.Y. TIMES, Jan. 24, 1953, at 8.

²²⁰ *National City Lines, Inc.*, DC-IL, 118 FSupp 465 (1953).

²²¹ See *National City Lines, Inc.*, CA-7, 186 F2d 562 (1951). For those unfamiliar with the National City Lines (NCL) conspiracy, the scandal begins in the 1930s. Few people remember, but by the 1930s, the United States had one of the most extensive and sophisticated electric street car systems in the world. Street cars systems were started by the electric companies, which owned rights of way that snaked underneath the overhead power line systems that snaked through our cities and used the street car idea as a way to squeeze additional revenue out of their power line systems. Since every major city had an electric company, virtually every major city had an electric street car system. Ironically, the Los Angeles system was among the finest in the nation.

From the perspective of the automobile, oil, and tire industries, the problem with electric street cars was that they did not require drivers, gasoline or tires, which made them a direct competitor to companies that sell cars, oil, and tires. This issue laid the groundwork for a

criminal antitrust conspiracy among some of the largest corporations at the time—General Motors, Standard Oil of California (Socal), Phillips Petroleum, Mack Manufacturing (the truck manufacturer) and Firestone Tire & Rubber. Those companies formed and funded NCL. NCL had a fairly simple operating model. It would acquire privately owned street car line systems in a particular city, rip out the streetcar lines and replace them with motorized buses. The buses, of course, were manufactured by GM and Mack, ran on tires made by Firestone, and used gasoline produced by Phillips. See Jonathan Kwitny, *The Great Transportation Conspiracy*, HARPER'S MAGAZINE, Feb. 1981, at 14–21.

One aspect of the conspiracy in particular illustrates the validity of the policy objectives underlying the corporate tax. Early on, the participants in NCL realized that the process of buying street car lines, destroying the street car infrastructure, and replacing that infrastructure with motorized buses might not make economic sense unless one took into account the future profits that could be made on the sale of buses, tires, oil and, in the case of GM, cars as well (the idea being that people would rather buy a car than ride a bus). In order to establish the stand-alone viability of NCL, NCL attempted to obtain debt and equity funding from banks, brokers and underwriters. Because NCL was not economically viable on a stand-alone basis, those fundraising efforts proved fruitless, which brings us to the topic of retained earnings—it appears that the primary source of funding for NCL was the retained earnings of its shareholders (*i.e.*, GM, Socal, Phillips and Mack).

From the record as we have it, it would appear that the entire NCL street car scandal might not have occurred but for the accumulation of the retained earnings used by NCL's shareholders to fund NCL's operations. The NCL scandal in some ways is the poster-child for the policy objectives that that prompted Congress and President Taft (and Roosevelt before him) to push for the corporate tax in 1909. See generally, A STUDY OF THE ANTI-TRUST LAWS: HEARINGS BEFORE THE SUBCOMMITTEE ON ANTI-TRUST AND MONOPOLY OF THE COMMITTEE ON THE JUDICIARY, UNITED STATES SENATE, PART VI, GENERAL MOTORS, 84th Cong. 1st sess., Part 6.

²²² The one piece of commentary we have found making these arguments is Channing, *supra* note 104, at 509–510, written in 1958, between the vetoing of the first legislative REIT proposal in 1956 and the eventual enactment of the 1960 REIT Legislation in 1960. Under a heading entitled “Should Real Estate Investment Trusts Be Taxed?”, Channing presciently argued:

If the foregoing [argument about why “conduit” securities investment vehicles, such as RICs, generally should not be taxed] is true in general, the law should not have been framed to tax the income of conduits generally in the first place, and the argument here *ought* to be whether an exception from the general

rule [of non-taxation] should be made to make the income of real estate investment trust taxable . . .

Id., at 509–510 (Emphasis in original).

²²³ It is unlikely that either RICs or REITs were contemplated by Congress when drafting the 1909 Act. See REVENUE ACT OF 1936: CONFIDENTIAL HEARINGS ON H.R. 12395 BEFORE THE SENATE COMM. ON FINANCE, 74th Cong., 2d Sess. (remarks of Arthur Kent, Acting Chief Counsel to the Bureau of Internal Revenue), pt. 10, at 61 (“I am not certain that Congress actually intended to include them [*i.e.*, RICs], or that this situation was considered when the association definition was written into the Act.”).

²²⁴ See, *e.g.*, *Eliot*, 220 US 178 (1911), discussed above in Part IV.A.2(b). *Eliot* is notable for its detailed description of a real estate trust in 1911. Like modern REITs, the Cushing Real Estate Trust at issue in the case was organized in order to purchase, improve, hold and sell properties. Control of the trust was vested in the trustees, who apparently possessed powers similar to a modern board of directors. Trust shares, like modern REIT shares, were freely transferable. The trust gave no shareholder any right to the trust's property, only to dividends made out of net income and net proceeds:

[The case concerns] a certain trust formed for the purpose of purchasing, improving, holding, and selling lands and buildings in Boston, known as the Cushing Real Estate Trust. By the terms of the trust, the property was conveyed to certain trustees, who executed a trust agreement whereby the management of the property was vested in the trustees, who had absolute control and authority over the same, with right to sell for cash or credit at public or private sale, and with full power to manage the property as they deemed best for the interest of the shareholders. The shareholders are to be paid dividends from time to time from the net income or net proceeds of the property, and twenty years after the termination of lives in being, the property to be sold, and the proceeds of the sale to be divided among the parties interested The shares were transferable on the books of the trustees, and on surrender of the certificate, and the transfer thereof in writing, a new certificate is to issue to the transferee. No shareholder had any legal title or interest in the property, and no right to call for the partition thereof during the continuance of the trust.

²²⁵ Company towns were probably aimed more at vertical integration and companies keeping control over workers and preventing unionization. Also, company towns may have been evidence of (i) lack of financing for households to purchase real estate, and (ii) the fact that real estate companies may have been reluctant to become too exposed to one employer (*e.g.*, an apartment company might not want to build

a new building in a one factory town because of the risk that the factory might shut down or move operations somewhere else).

²²⁶ See, *e.g.*, Channing, *supra* note 104, at 510 (“In the real estate trust situation, it is plain that the dangers of monopoly do not exist in anything like the degree in which they are present in the securities situation [*i.e.*, where companies own controlling interests in non-real estate companies]”). Channing recognized the relevance of monopoly to the question of whether collective investment vehicles, such as RICs and REITs should be subject to the corporate tax:

In the interests of a sound tax structure, and for other reasons, it is absolutely necessary to confine the tax-exemption to entities which limit their activities entirely to acting as investment media to the exclusion of all else. If securities investment companies, for example, were permitted to acquire controlling interests in great industrial corporations, they would necessarily assume the responsibilities that go therewith. In so doing they would tend inevitably to lose their character as investors as they became more and more obligated to engage in the business they had come to control, and it is conceivable that they could grow into monopolies of economic power.

Id.

²²⁷ See Borden, *supra* note 9, at 542.

²²⁸ See generally Borden, *supra* note 9.

²²⁹ Code Sec. 857(a)(2).

²³⁰ See Equinix, Inc.'s 2015 Form 10-K at 15 (2015 conversion, approx. \$600 million distribution); Iron Mountain Incorporated's 2014 Form 10-K at 29 (2014 conversion, approx. \$700 million distribution); Outfront Media Inc.'s 2014 Form 10-K at 6–7 (formerly CBS Outdoors America Inc.) (2014 spin-off, \$547.7 million distribution); CareTrust REIT, Inc.'s 2014 10-K at 55 (2014 spin-off, \$132 million distribution).

²³¹ See McRae Thompson, *C Corporation to REIT Conversions—A Closer Look at the Tax Consequences*, 17 BUS. ENTITIES 3, 9 (2015) (“In the context of a REIT conversion transaction, [the purging dividend] results in a one-time taxable dividend event which may have never occurred without the REIT conversion. This insures that all current and prior C corporation earnings and profits attributed to the REIT are subject to the double tax that would have applied under the C corporation regime and results in a sometimes significant acceleration of the investor-level taxation on the shareholders which otherwise may have continued to be deferred indefinitely.” (Emphasis in original)).

²³² See, *e.g.*, Boos, *supra* note 21, at 1289 (“[T]he ability for taxable REIT subsidiaries (TRSs) to perform many of the services that would otherwise disqualify most entities from operating as a REIT has allowed virtually any company with significant real estate holdings to reduce its tax bill.”); *id.*, at 1291 (“Perhaps the most effective way to curb the growth of REIT expansions is

to repeal the permissibility of TRSs ... [T]he existence of the TRS negates the original passive function of the REIT itself.”).

²³³ See Code Sec. 856(b)(5)(B) (1960).

²³⁴ We acknowledge, as some REIT critics have, that the meaningfulness of TRSs’ paying tax on their income depends on the IRS’s ability to enforce transfer pricing rules that are designed prevent TRSs from shifting too much income to their REIT parents. See, e.g., Boos, *supra* note 21, at 1291 (arguing that “the potential for transfer pricing abuse between the REIT and the TRS is ... [a] justification for Congress to consider repealing the TRS statute”). Because the Code imposes very harsh penalties on REITs that act on non-arm’s-length terms with their TRSs, see, e.g., sources cited *supra* note 53, this issue is only one of enforcement and does not represent a theoretical policy problem with the use of TRSs. In that regard, contrary to REIT critics’ claims that “REITs are audited relatively rarely,” see *id.*, at 1293, we can attest from our own experience that audits of TRSs are becoming increasingly common, with transfer pricing issues normally being the focus of the audit.

²³⁵ See *supra* Part II.B.3.

²³⁶ Obviously, this structure only works where the REIT owns all (or at least a super majority) of the shares of the TRS. In order to prevent unexpected REIT income test issues, any mandatory TRS dividend would have to either be disregarded for purposes of the REIT income tests in a manner similar to hedging income, see Code Sec. 856(c)(5)(G), or treated as qualifying income for purposes of the 75-percent income test.

²³⁷ See, e.g., Boos, *supra* note 21, at 1290 (“Lawmakers ... might conclude that the recent expansion of the definition of real property is problematic and requires a reining in of REITs.”); Lee A. Shepard, *Can Any Company Be a REIT?*, 140 Tax Notes 755, 755 (2013) (“IRS REIT conversion rulings over the last few years have been expansionary interpretations of the statute.”); Popper, *supra* note 24 (“[B]it by bit, especially in recent years, ... the I.R.S., in a number of low-profile decisions, has broadened the definition of real estate ...”); Glanz, *supra* note 24 (“The I.R.S. ... ‘is letting people broaden these definitions [of real estate] in a way that they kind of create the image of a loophole.” (quoting Ryan Alexander, president of Taxpayers for Common Sense)).

²³⁸ The definition of “real property” is crucial both from an income test perspective (*i.e.*, in order to determine whether particular rental income is “rents from real property”), as well as an asset test perspective (*e.g.*, in order to determine how much of the REIT’s assets are good “real estate assets” for purposes of the 75-percent asset test, a term that includes interest in “real property”).

²³⁹ Ever since 1962, the regulations under Code Sec. 856 have contained the following definition of real property:

The term “real property” means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are

structural components of such buildings or structures) Local law definitions will not be controlling for purposes of determining the meaning of the term “real property” as used in section 856 and the regulations thereunder. The term includes, for example, the wiring in a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.

Reg. §1.856-3(d) (Emphasis added). It is important to note that an asset that is otherwise real property will not cease to be real property—will not be treated as accessory to the operation of a business—*simply because it is used in an active business*. As the IRS has stated in a memorandum that addressed certain broadcast towers and related assets:

You also argue that Congress intended that REITs invest only in certain passive type investment property and that the tower and facilities will be operated as an active business. However, Congress was concerned with the lessor[REIT] conducting a business and not with the fact that the leased assets might be used by the lessee in the active conduct of a business. Obviously, a lessee occupying a hotel or factory would be using them in the active conduct of a business but the trust would still qualify if its participation was properly limited. Here, under the terms of the lease, the lessee will operate the business and the [REIT]’s involvement will be as passive as the lessor of an apartment building, factory, or hotel.

General Counsel Memorandum 32907 (Sept. 3, 1964).

The definition has two key prongs: First, an asset, if it is not land or a building, must be an “inherently permanent structure,” a term that includes a “structural component” of a building or other inherently permanent structure. Second, the asset must not be “accessory to the operation of a business.”

The meaning of the first prong is clearer than the second, though neither is obvious from the face of the regulation. With respect to the first prong (“inherently permanent structure”), although no Code section, regulation or REIT authority defines the term, it is reasonably clear at this point—both from case law in non-REIT contexts that has defined the same term and

from the IRS’s own REIT ruling history—that the focus is on the degree of permanence with which the relevant asset is affixed to land or a building. In other words, how difficult is the asset to move and how unlikely is it that the asset will be moved? The harder and less likely it is to move, the more likely it is real property.

The precise meaning of the second prong (“asset accessory to the operation of a business”) is far less clear, though what is reasonably clear is that it depends on the function of the asset (*e.g.*, what it actually does and what purposes it serves) rather than its degree of movability, and in particular on some notion that the asset is sufficiently “passive” in function (whatever that means). Beyond saying that, it is difficult to distill all of the relevant authorities into a single statement (or few statements) of law, and although we have a theory on what those statements might say, fleshing that out is beyond the scope of this article and would only be a distraction from our main point, which is that the IRS’s general approach to defining real property has not changed.

²⁴⁰ See Proposed Reg. §1.856-10, REG-150760-13, 79 FR 27,508 (May 14, 2014). For example, the proposed regulations contain a safe harbor list of assets that automatically qualify as real property, Proposed Reg. §1.856-10(d)(2)(iii)(B), (3)(ii), many of which were previously the subject of published and private IRS rulings, such as microwave and cellular transmission towers (Rev. Rul. 75-424, 1975-2 CB 269; LTR 201129007 (Apr. 6, 2011); LTR 201206001 (Aug. 16, 2011)); railroad tracks, bridges and tunnels (Rev. Rul. 69-94, 1969-1 CB 189); transmission lines (LTR 200725015 (Mar. 13, 2007)); pipelines (LTR 200937006 (Mar. 3, 2009)); and certain outdoor advertising displays (LTR 201522002 (Feb. 27, 2015); LTR 201431020 (Apr. 16, 2014); LTR 201431018 (Apr. 22, 2014)). Assets that are not on the safe harbor list are classified under a facts-and-circumstances test that, familiarly, focuses largely on the asset’s movability and its passiveness. The framework of the proposed regulations is thus largely consistent with the IRS’s approach to defining real property over the last 50 years.

²⁴¹ When it comes to technological developments creating REIT assets that did not exist in 1960, the first example that comes to mind is the cell phone tower. Back in the 1960s, consumer-grade wireless communication systems did not exist, and most government and commercial wireless communications systems relied on low frequency ranges (typically below 175 mhz, and occasionally as high as 460 mhz) that required the use of a small number of high power transmitters located atop tall buildings, mountains or towers. Fifty years later, 10-year-old children are running around with smart phones that transmit on extremely high frequencies (typically above 800 mhz) and that require the use of a large number of very low power transmitters located in many different locations. These developments helped spawn the cell tower sector of the REIT industry. See, e.g., LTR 201129007 (Apr. 6, 2011)

(modern ruling on cell towers); LTR 201206001 (Aug. 16, 2011) (same).

²⁴² See, e.g., LTR 201537020 (May 22, 2015) and LTR 201314002 (Oct. 9, 2012). Fiber-optic network systems and data centers provide an interesting example of how technological developments can change the appearance of an asset without changing its essential function or its tax classification as real estate. Fiber-optic network systems move data from one place to another at a high rate of speed. Although they operate using completely different technology, fiber optic network systems perform the same basic function the pneumatic tube systems of the 19th century.

Pneumatic tube technology originated in Europe in the early 19th century and quickly became popular as a fast way to transmit messages and data from one place to another. A pneumatic tube system can be localized to a single building or can be used to link together multiple buildings (e.g., a brokerage house can be linked to a stock trading room, a telegraph station can be linked to an office building). By the 1950s, these systems had become standard fare in major city office markets, and were viewed as essential to the rapid transmission of information that could not be moved *via* telegraph or telephone (e.g., contracts and larger objects).

Although the authors could not locate any authorities discussing the classification of pneumatic tube systems for purpose of the REIT rules, it seems clear that the system, as a standard feature of office buildings in Manhattan through the 1960s, would qualify as real estate under the 1960 regulations.

When it comes to data centers, we found an interesting example of how an entire building can adapt to changes in technology without changing its essential function: 60 Hudson Street in Manhattan's Tribeca neighborhood, which was designed in the 1920s for the Western Union Telegraph Company and was a technological masterpiece that included an extensive telegraph system and one of the largest pneumatic tube networks then in existence in the United States.

In addition to having its own internal pneumatic tube system, the Western Union building on Hudson Street was a nerve center that connected to a larger pneumatic tube system that provided access to critical buildings located throughout lower Manhattan. In that way, a person could send a pneumatic tube canister to the Western Union building, where the canister could be relayed to another building somewhere else in the city. See *Skyscraper Begun by Western Union*, N.Y. TIMES, August 22, 1928, at 32.

With a pneumatic tube system looking and functioning in much the same way as a fiber optic network system, it ought not be surprising that, when it opened in the 1930s, the Western Union building was a data transfer point and storage center for data transmitting devices. From the perspective of this article, the most interesting part of the story is that, although the Western Union building may have traded hands

over the years, it has never changed its essential function—it is now one of the largest and most important internet and data connectivity points in the world. See Andrew Friedman, *Pneumatic Tubes are Reincarnated in the Digital Age*, N.Y. TIMES, April 29, 2001 (“Before, one carrier used this entire building and these arcane devices,” said Trey Farmer, executive vice president of FiberNet, the company creating the room, which will allow telecoms to use one another’s networks and outsiders to tap into the building’s fiber optics. “This is its modern evolution. The more we learned about the building, the more it became this uncanny analogy.”).

²⁴³ For example, electricity transmission and distribution systems have, until recently, been owned by utilities, rather than third parties that leased to the utilities.

²⁴⁴ Jones, Sct, 132 Sct 945 (2012).

²⁴⁵ *Kyllo*, Sct, 533 US 27 (2001).

²⁴⁶ See Arthur C. Clarke, PROFILES OF THE FUTURE: AN INQUIRY INTO THE LIMITS OF THE POSSIBLE 36 (1962) (“Any sufficiently advanced technology is indistinguishable from magic.”).

²⁴⁷ Among the many rulings the IRS has issued over the years on the meaning of “real property” and “real estate assets,” two early published rulings in particular—Rev. Rul. 69-94, 1969-1 CB 189 (the “Railroad Ruling”), and Rev. Rul. 75-424, 1975-2 CB 269 (the “Transmission Tower Ruling”)—are seminal and probably among the more frequently cited published rulings in IRS private rulings on “new” asset classes,^[247] probably as a consequence of being good analogies for many of those new assets.

In the Railroad Ruling, a REIT owned land that it had acquired from a railroad, along with certain railroad assets related thereto, including the trackage, roadbed, buildings, bridges and tunnels used by the railroad. The IRS, without much reasoning, ruled that the railroad assets were not “accessory to the operation of a business” and thus were real property for purposes of Code Sec. 856. Despite the lack of reasoning, it is clear that the IRS’s conclusion comports with the two-pronged analysis described above—few assets, buildings included, are much more permanent than railroad tracks, roadbeds, bridges and tunnels, and whatever “passive” means for purposes of the second prong, it is hard to envision how these types of assets are not passive and thus not accessory to the operation of a business.

Though the Railroad Ruling is important, the Transmission Tower Ruling is probably even more influential. There, the IRS addressed the real property status of certain systems for the transmission of audio and video signals *via* microwaves. The microwave system consisted of several components: towers built upon pilings or foundations; antennae that transmit and receive microwaves and that are affixed to the top of the towers; certain equipment that processes the microwave signals and is housed in a nearby building; “modular racks” that support the equipment and are wired or bolted to the floor and ceiling of the building; certain

“waveguides” that were affixed to the towers; a permanent HVAC system in the building that houses the equipment; and fencing surrounding that building. The IRS ruled that the towers, the HVAC system, and the fencing were “real estate assets” for purposes of the REIT rules but that the antennae, waveguides, equipment, and modular racks were “assets accessory to the operation of a business” and thus not “real estate assets” under the REIT rules.

These rulings have been cited, and consistently applied, many times in more recent private letter rulings.

²⁴⁸ See Elaine Misonzhnik, *Party Crashers: The House Ways and Means Committee Seeks to Put an End to the Proliferation of Non-Traditional REITs*, 56 NATIONAL REAL ESTATE INVESTOR 55, 55 (Sept./Oct. 2014) (“There is an obvious tax benefit to [becoming a REIT], but it is also driven in part by favorable capital markets conditions.” (quoting Bob O’Brien, vice chairman of the U.S. real estate services practice at Deloitte)); Brad Thomas, *REIT Sector Crackdown is Simply Foolish*, THE STREET (Apr. 29, 2013), available online at www.thestreet.com/story/11907794/1/reit-sector-crackdown-is-simply-foolish.html (“It’s clear that the increased demand [for REIT stocks] is not driven by the corporate tax exemption Instead, it seems the strong demand is driven by Mr. Market. REITs today are trading at very high multiples and that has created an environment fueled by low cost debt and equity.”).

²⁴⁹ See Misonzhnik, *supra* note 249 (“[W]hat’s far more likely [than a change in the definition of ‘real estate’] to slow down the desire for REIT conversions in the near term is the anticipation of higher interest rates, O’Brien says. If interest rates spike and investors lose their appetite for REIT stocks, REIT spin-off [sic] will look a lot less attractive.”); Hough, *supra* note 25 (“Ultralow bond yields have sent investors scrambling for income, and REITs have become a favorite holding.”); see also Thomas, *supra* note 248 (“A few weeks back I caught up with Brad Case, Ph.D., CFA, and CAIA, senior vice president of research and industry information with NAREIT, and he provided me with a value proposition for a REIT dividend vs. a non-REIT dividend: ‘There’s a big difference between cash that a company has because it raised it externally to finance a planned acquisition [e.g., as a REIT would], and cash that it has because it refused to pay dividends to shareholders. Academic researchers have found time and time again that executives have a tendency to make poor use of free cash on hand, whereas when they have to undergo “capital market scrutiny,” they tend to make decisions that are better for shareholders. That may be part of the reason why listed REIT returns have been systematically better than non-REIT stock returns, not just recently but over more than four decades of available history.”); A.D. Pruitt & Amol Sharma, *IRS Puts Breaks on Corporate Push to Capture Real-Estate Tax Break*, WALL ST. J.,

June 7, 2013, available online at www.wsj.com/articles/SB10001424127887324299104578531101364286158 ("REITs are popular with individual investors seeking higher yielding securities.").

²⁵⁰ See *supra* Part II.C.

²⁵¹ See IV.B.1.

²⁵² See sources cited at *supra* note 200.

²⁵³ See sources cited at *infra* note 261.

²⁵⁴ See STOCK EXCHANGE PRACTICES: REPORT OF THE COMM. ON BANKING AND CURRENCY, S. REP. NO. 1455, 73d Cong., 2d Sess. 333 (1934); see also Roe, *supra* note 12, at 1472; Channing, *supra* note 104, at 510 ("The dangers [of monopoly by investment companies] have been met, and apparently effectively met, by confining the interest which a regulated investment company can hold in any one company to a percentage, and by other restrictions.").

²⁵⁵ Depending on the governance structure of the companies, the RIC could potentially vote for all directors of all four companies with only 51 percent of the stock of each company.

²⁵⁶ See Legal Advice Issued by Associate Chief Counsel, 2009-010 (Oct. 2, 2009).

²⁵⁷ *Id.*

²⁵⁸ See, e.g., New Mountain Finance Corporation, Form N-2, May 9, 2011, at 2 ("We expect to make investments [in loans] through both pri-

mary originations and open-market secondary purchases."); *id.*, at 115 (describing New Mountain's "private equity investment strategy"); Corporate Capital Trusts II, Form N-2, October 1, 2015, at 4 ("We intend to pursue a strategy focused on investing primarily in the debt of privately owned U.S. companies with a focus on originate transactions"); Hercules Technology Growth Capital, Inc., Form N-2, September 29, 2015, at 1 ("We are a specialty finance company focused on providing senior secured loans to venture capital-backed companies in technology-related industries").

²⁵⁹ Rev. Rul. 67-353, 1967-2 CB 252 (1967).

²⁶⁰ See, e.g., Sheppard, *supra* note 238 ("The value of [data centers] comes from power services and proximity rather than square footage in Weehawken ... [A]s a financial matter, [data center owners] could be considered power and telecom resellers, even though they are not regulated as utilities."); Glanz, *supra* note 24.

²⁶¹ See Channing, *supra* note 104, at 510 ("[I]n principle there is no basis for distinguishing between dividends, interest, and rents.").

²⁶² In other words, if one shifts focus from the things that are being done in order to earn a return to the type of return being earned, we can see very quickly that, just as a RIC may do things in order to earn interest income, so too

might a REIT do things in order to earn rent. For example, it ought to be common knowledge that most commercial tenants (artists excluded) do not want to rent physical space in a dilapidated building, even if the building is well located. At some point, somebody somewhere has to do something in order to get the property in a state where a commercial tenant will want to pay money in order to occupy the property. Once it is acknowledged that certain types of activities—e.g., repairing the property, maintaining the property, providing security, trash removal, *etc.*—are consistent with the receipt of "passive" rental income, we've established that "doing things" to earn rental income is not inconsistent with a REIT's status as a "passive" entity. As properties move up market, the demands for tenant services will increase, and unless Congress decides to ban REITs from the upmarket real estate sector (which would be a complete reversal of the populist and capital markets policies underlying the 1960 REIT Legislation), the level of services demanded by tenants at a particular property ought to be irrelevant to the determination of whether or not the property belongs inside a REIT, so long as the amounts received by a REIT are tied to the tenant's use of the property.

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