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Paul E. Anderson

Thomas G. Cody

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TAX AND ACCOUNTING

TAX CONSIDERATIONS OF THE CONDOMINIUM SPONSOR AND PURCHASER

PAUL E. ANDERSON* AND THOMAS G. CODY**

Perhaps no other form of real estate ownership has received more public attention over the past few years than the legal animal known as the condominium. It is the purpose of this article to examine the condominium from the point of view of federal income tax consequences to the owner-sponsor, the buyer-unit owner and the condominium itself.

CAPITAL GAIN PROBLEMS OF THE OWNER-SPONSOR

The sale of a condominium involves the sale of real property. Consequently, among the problems to be faced by the owner-sponsor is the rather significant one of whether conversion and sale will result in long-term capital gain or ordinary income. This problem involves that question of fact which accompanies each development, ownership and sale of condominium units: Do the units constitute property held by the owner-sponsor "primarily for sale to customers in the ordinary course of his trade or business?"¹ Assume a set of facts:²

The XYZ Real Estate Partnership, a limited partnership, acquired the Plancourt apartment project on June 1, 1956. The project, which was built in 1949 at a cost of \$25 million, was purchased by the partnership for \$45 million. The project was the sole asset of the partnership and none of the partners held any other real estate investments. In 1972, the partnership determined that the return on this investment was not sufficient to justify maintaining the Plancourt apartment project. Consequently, the partnership, realizing that its profits could be maximized by converting Plancourt into a condominium, prepared a plan to offer the apartments as units to the tenants of Plancourt. In preparation for filing the plan and offering the units, the partnership

* Adjunct Professor of Law, University of California, Hastings College of Law. A.B., University of Michigan, 1948; J.D., University of Michigan, 1950.

** Assistant Professor of Law, St. John's University School of Law. B.A., Maryknoll College, 1964; J.D., St. John's University, 1967.

¹ See INT. REV. CODE of 1954, §§ 1221(2), 1231(b)(1)(A),(B).

² This fact pattern depicts the situation between the extremes of (1) outright sale of an entire property (as a unit) concededly held as an investment for a period of time and (2) of the subdivision and sale of property acquired with the primary purpose of so doing.

increased the size of the Plancourt maintenance and security forces; hired a corporation, wholly-owned by the partners, to conduct advertising and sales activities in an office located in the project; and contracted for substantial renovation of electrical systems, landscaping and building exteriors. What result to the partnership, and therefore to the partners,³ on sale of the units with respect to the nature of the gain realized?

In examining this question, it is necessary to review briefly (1) the nature of a capital asset and (2) the somewhat vague rules governing conversion from investor (capital gain) to dealer (ordinary income) status. Having done that, we shall examine certain alternative approaches to the proposed Plancourt conversion and sale to determine what effect they have on the risk of dealer status. More specifically, we shall examine the liquidation of investment approach and the use of a middleman.

The Capital Asset

The Internal Revenue Code defines a capital asset by defining in sections 1221 and 1231 what it is not, *i.e.*, it is all property held by a taxpayer other than certain items enumerated in the statute. Section 1221 provides that the following are to be excluded from the category of capital asset: (1) inventory; (2) property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (3) depreciable business property and real estate used in a trade or business (the Plancourt property);⁴ (4) certain copyrights and literary, musical or artistic compositions; (5) accounts receivable acquired in connection with (1) and (2) above; and (6) certain short-term governmental obligations. Section 1231, which enunciates special rules to be applied in the capital gain inquiry for business property, parallels section 1221. Section 1231, as does section 1221, spells out those assets not entitled to capital treatment. Among them are inventory and property held primarily for sale to customers in the ordinary course of business. Thus, under both sections 1221 and 1231, inventory and property held "primarily for sale" are excluded from capital asset status. It is the latter provision, the "primarily held for sale" category, which is treated herein.

Held Primarily for Sale

The question of whether an item is held primarily for sale to customers in the ordinary course of a taxpayer's trade or business is

³ INT. REV. CODE of 1954, §§ 701, 702(c).

⁴ *Id.* § 1221(2).

necessarily one of fact. Consequently, there are no clearly defined guidelines which can be applied to reach a determination in every case. Nevertheless, there are situations wherein it is fairly clear the property is or is not held primarily for sale to customers in the ordinary course of business.

Under the Treasury Regulations,⁵ it is taken as a given that a real estate dealer *probably* holds real property primarily for sale in the ordinary course of his trade or business. On the other extreme, it is equally probable that an individual who is not in the real estate business and who purchases one parcel of property, holds it for six years and then sells it as a unit has not held the property primarily for sale. Difficulty arises where the taxpayer is neither a professional dealer in real property nor a person who involves himself with an isolated investment transaction. What is the character of the gain realized by a non-dealer with a history of purchases and sales? How is the purchaser of a tract to be treated when he attempts to maximize resale profit by liquidating his investment in parts? In these transactions, there is a very real question as to whether the "primarily" prescription has been avoided.

The question of the meaning of the word "primarily" was before the United States Supreme Court in *Malat v. Riddell*.⁶ The facts were as follows: Malat had participated in a joint venture formed to acquire a 45-acre parcel of land. There was conflicting evidence as to whether the land was acquired solely for the purpose of development and operation of an apartment project or whether it was acquired with a dual purpose of development and/or subdivision and resale, depending upon profitability. The Supreme Court, rejecting a lower court view that "primarily" should be equated with the relatively easily met test of "substantial," held that "primarily" means "of first importance" or "principally."⁷ The Court, vacating and remanding,⁸ stated that the purpose of the language of section 1221(1) was to draw a distinction between the "'profits and losses arising from the everyday operations of a business' on the one hand . . . and 'the realization of appreciation

⁵ Treas. Reg. § 1.1221-1(b) (1957). It should be emphasized at this point that being in the real estate business does not automatically preclude capital gain treatment. See *Maddux Constr. Co.*, 54 T.C. 1278, 1286 (1970), discussed in text accompanying note 16 *infra*. Again, in *Eline Realty Co.*, 35 T.C. 1 (1960), the Tax Court stated: "It is well established that a dealer in real estate may occupy a dual role: He may be a dealer with reference to some of his properties, and an investor as to others . . ." *Id.* at 5.

⁶ 383 U.S. 569 (1966), *vacating and remanding* 347 F.2d 23 (9th Cir. 1965).

⁷ 383 U.S. at 572.

⁸ On remand, the district court held that the land was *not* held primarily for sale within the meaning of section 1221(1). 275 F. Supp. 358 (S.D. Cal. 1966).

in value accrued over a substantial period of time' on the other"⁹ The Court thus rejected the Internal Revenue Service's view that "primarily" should be equated with the test of substantial purpose. This latter test would be satisfied (with resultant ordinary income treatment) whenever there existed a not-insignificant resale motive.

The first step in determining the nature of the gain is to recognize that the presence of two (or more) purposes and the existence of an intent to resell in the manner most profitable (including subdivision and resale) will not of *themselves* cause the asset to fail the "primarily" test. The question then is not whether there exists a motive to sell the property in the ordinary course of business, but whether that motive is principal, major, or most significant. Returning for a moment to the fact pattern assumed above, does *Malat* offer us a route to a determination of the nature of the asset in the hands of the XYZ Real Estate Partnership? Between 1966 and 1972, it would appear that the apartment project was held as an investment. It would, of course, be naive to assume that the partnership did not constantly evaluate the worth of its investment and review the possibilities of elimination of the investment at the highest possible profit. Nevertheless, it would seem proper to argue that during this period the primary character of the holding was as an investment — not as property held for sale (primarily) to customers in the ordinary course of business. But what of the decision in 1972 to dispose of the investment in the most profitable manner, that is, to convert the project to a condominium and sell each of the apartments as an independent unit? Has the "primarily" test now been met?

The language of sections 1221(1) and 1231(b)(1)(B) does not address itself solely to the question of intent at the time of acquisition. The Code uses the word "held," and thus frames the issue as of a point in time, somewhere prior to the actual moment of sale. As noted in *United States v. Cook*,¹⁰ which, although it did not deal with real property, was concerned with the "primarily held for sale" test:

the critical period for characterization of the property goes further back than the time of disposition. The property is properly characterized at the time it is acquired for use by the taxpayers in their trade or business *and* during the period it is so used. . . . There is no requirement in the statute that the property be used in the trade or business right up to and including the date of sale or exchange.¹¹

⁹ 383 U.S. at 572 (citations omitted).

¹⁰ 270 F.2d 725 (8th Cir. 1959).

¹¹ *Id.* at 729 (emphasis added).

Consequently, the question is whether the decision to terminate ownership of the project through conversion to a condominium and a sale of units causes the property then, at the time of decision, to be held primarily for sale to customers in the ordinary course of business. There is no obvious or even relatively certain answer to this question although, as noted, it is clear that the mere instant of sale is not the relevant point to begin the inquiry.¹² Some guidance can be found in the "tests" used in the many cases treating the question of dealer vs. investor and by examining the facts which cause investor status to be terminated and dealer status created.

Dealer versus Investor

It is clear that if the XYZ Real Estate Partnership had sold the property as an entirety, capital gain characterization would probably result (except for possible recapture of depreciation under section 1250 of the Code).¹³ The courts have consistently recognized that Congress intended to afford capital gains treatment in those situations "typically involving the realization of appreciation in value accrued over a substantial period of time. . . ." ¹⁴ Plancourt has been owned for several years and has been held as an income producing investment. Its appreciation in value is now being realized.

Just as clearly, if the partnership had purchased the project, and within a short time converted it to a condominium, or had purchased undeveloped land, and constructed the condominium and sold the units, there would not be that substantial period of ownership¹⁵ ac-

¹² As pointed out in 3B J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 22.138, at 628-29 (1974):

If the taxpayer's situation is examined at the very moment the property is sold, it will invariably be found that there was an intent to sell, but such a literal approach would nullify the statutory provisions conferring capital gain or loss treatment, and would seem to go beyond the legislative intent behind the exclusion involved.

¹³ Under section 1250, as amended by the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969), gain from the sale or exchange of depreciable real property may receive ordinary income treatment to the extent of the excess of depreciation taken over what would have been taken had the straight line depreciation method been used.

¹⁴ *Commissioner v. Gillette Motor Co.*, 364 U.S. 130, 134 (1960). See *Commissioner v. Brown*, 380 U.S. 563 (1965), wherein Mr. Justice White states:

Obviously on these facts [sale of stock on the installment method], there had been an appreciation in value accruing over a period of years . . . and an "increase in the value of the income producing property." This increase taxpayers were entitled to realize at capital gains rates

Id. at 527 (footnotes omitted).

¹⁵ See Spandorf, *Capital Gain Opportunities for Sponsors of Co-ops and Condominiums*, N.Y.U. 31ST INST. ON FED. TAX. 1855 (1973), where the author states:

Thus, it would appear that an acquisition or development of apartment rental property for relatively quick conversion to cooperative [or condominium] ownership will not achieve long-term capital gain treatment of the profits to be made

accompanied by appreciation in value which would lead to capital gain characterization. But, the XYZ Real Estate Partnership has held the property for a "substantial" period of time. The partnership did purchase it with a view towards holding it as an investment. Does the act of conversion now cause this "investment" to become the equivalent of a "primarily held for sale" condominium unit?

In *Maddux Construction Co.*,¹⁶ the Tax Court held that a tract of undeveloped land was not held by the taxpayer primarily for sale to customers in the ordinary course of trade or business even though the taxpayer was in the business of developing residential real estate. In so holding, the court listed nine factors to be considered in answering the question of "primary" purpose: (1) the purpose for which the property was originally acquired; (2) the purpose for which it was thereafter held; (3) how extensive were the improvements made to the property; (4) how frequent, how many and how continuous were the sales; (5) the extent and nature of the transactions involved; (6) the taxpayer's normal business; (7) the extent of the advertising, promotional or other efforts of the taxpayers in soliciting buyers; (8) the involvement of brokers; and (9) the purpose for which the property was held at the time of sale.¹⁷ These factors are not all-inclusive, but they give an indication of the type of scrutiny under which the courts will place the transaction.¹⁸

by the sponsor. It is suggested that the ownership of the apartment house obtain the earmarks of a long-term holding period before being offered to its tenants.

Id. at 1863.

¹⁶ 54 T.C. 1278, 1284 (1970).

¹⁷ *Id.* at 1284.

¹⁸ In *Brandenburger v. United States*, No. S-1377, S-1496, 73-1 U.S. Tax Cas. ¶ 9316 (E.D. Cal. 1972), the court, in instructing the jury, stated that the jury should consider the following in determining whether the property was held primarily for sale or primarily for investment:

1. The nature and purpose of their acquisitions of the properties.
2. The period of time during which the properties were held.
3. The use to which the properties were put during the period of ownership.
4. The extent of the developments and improvements made to the properties in order to ready them for sale.
5. The extent of any advertising campaign to promote sales.
6. The use of a business office by the plaintiffs for the sale of the properties.
7. The character and degree of supervision or control exercised by the plaintiffs over any representative selling the properties.
8. The time and effort the plaintiffs devoted to the sales of the properties.
9. The vocations of the plaintiffs at the time of the sales and prior and subsequent thereto.
10. The activities of the plaintiffs in purchasing, developing and selling real properties before, during and after the years of the sales in question.
11. The number and frequency of sales.
12. The existence of a liquidation intent at the time of the sales.
13. The replacement of the properties sold with additional real estate.
14. The amount of gain realized on the sales in question and whether the greater portion of this gain was attributable to appreciation in value over the

If the general guides set forth in *Maddux* are applied to the XYZ Real Estate Partnership, it is likely that the Internal Revenue Service will argue that ordinary income should result.¹⁹ While all will concede that the project was not acquired and initially held primarily for sale, the act of conversion would probably cause the income to be viewed as

period of ownership or was the result of the development and marketing activities of the plaintiffs or their agents.

Id. at 80, 677-78.

In *Eline Realty Co.*, 35 T.C. 1, 5(1960), the court stated:

The characterization of any particular asset as one held for sale or as an investment is a question of fact, which is resolved with the aid of certain well recognized tests, among which are: the intent of the seller with respect to the particular asset in question; the purpose for which the property was acquired, held and sold; the volume, frequency, continuity and substantiality of the sales; the proximity of sale to purchase; and the extent of sales activity on the part of the seller or his agents. These factors must be viewed in light of all the facts; no single factor is controlling. *W. T. Thrift, Sr.*, 15 T.C. 366; *Boomhower v. United States*, 74 F. Supp. 997. Moreover, while the purpose for the acquisition must be given consideration, intent is subject to change, and the determining factor is the purpose for which the property is held at the time of sale. *Carl Marks & Co.*, 12 T.C. 1196; *Richards v. Commissioner*, 81 F.2d 369; *Mauldin v. Commissioner*, 195 F.2d 714; *Raymond Bauschard*, 31 T.C. 910, 917, *aff'd*, 279 F.2d 115.

For a list of cases, both before and after the Supreme Court's decision in *Malat v. Riddell*, 383 U.S. 569 (1966), making the necessary factual determination of "primarily" or not, see 6 CCH 1974 STAND. FED. TAX REP. ¶ 4729.634.

¹⁹ The attitude of the Internal Revenue Service towards the sale of condominium units as opposed to sale of the entity is indicated in a proposed amendment to the Treasury Regulations applicable to real estate investment trusts. Under section 856(a)(4) of the 1954 Code, a real estate investment trust does not qualify for the pass-through treatment afforded by section 857 if it holds "any property primarily for sale to customer in the ordinary course of business." Section 1.856.1(d)(4) of the Proposed Treasury Regulations can easily be read to imply that the Service views the sale of units as constituting the proscribed "primarily for sale" activity:

Example (1). Trust M, which otherwise qualified as a real estate investment trust, has in its portfolio a construction loan for a condominium (single multi-unit dwelling). The loan originated with the trust and was made in accordance with prudent lending practices. The security for the loan is a mortgage on the condominium. After completion of the construction of the condominium, the debtor defaults on the loan and the trust becomes the owner of the condominium as a result of a foreclosure sale. The condominium is listed with a broker for sale as an undivided unit. The condominium is sold to an unrelated party within a reasonable period of time after foreclosure of the mortgage. . . . [T]he trust is not considered to have held the condominium primarily for sale to customers in the ordinary course of its trade or business merely because of the circumstances under which the foreclosure was made and the property was sold.

Proposed Treas. Reg. § 1.856.1(d)(4), 37 Fed. Reg. 26,014 (1972).

A similarly restrictive view was espoused by the Service in Rev. Rul. 73-398, 1973 INT. REV. BULL. No. 39, at 14, again involving real estate investment trusts. In this ruling, the Service was concerned with whether a decision to dispose of several long-term mortgages would convert them to "primarily held for sale" property. It was ruled that where: (1) a trust's investment policy of investing in long-term mortgages has resulted in a severe imbalance in its portfolio; (2) the trust has a valid business reason for balancing its portfolio in that the imbalance has affected its access to sources of additional funds; and (3) the trust has no history of portfolio sales and no intent to engage in further selling activity, then, a sale of several long-term mortgages for the avowed purpose of balancing its investments would not cause the mortgages to be viewed as held primarily for sale.

resulting from the various "merchandising" activities — sales activities, extensive renovation and the like. Consequently, the ordinary income test of profits and losses arising from the everyday operations of a business would be met.²⁰ The partnership had (1) increased the size of the maintenance and security forces; (2) engaged a corporation wholly-owned by the partners to conduct advertising and sales activities and furnished it an office on the premises; and (3) renovated electrical systems, landscaping and building exteriors. Keeping in mind that the purpose of the capital gain provisions of the Code have been interpreted as merely "intending to alleviate the burden on a taxpayer whose property has increased in value over a long period of time,"²¹ it becomes more evident that the XYZ Real Estate Partnership runs more than some risk of having a capital gains position defeated.

There are, however, certain courses open to the partnership which can minimize somewhat (although not eliminate) the risks of ordinary income treatment.

Liquidation of Investment

As noted above, the purpose of the capital gains provisions of the Code was to afford favorable income tax treatment when a taxpayer realized income attributable to appreciation in value which has occurred over a substantial period of time.²² The liquidation of investment theory is aimed at emphasizing the fact that there is no statutory bar to a taxpayer realizing the greatest amount of gain upon disposition of an investment.

In *Joan E. Heller Trust v. Commissioner*,²³ the taxpayer (who had a history of real estate activities) was a partner in a real estate development partnership. The partnership purchased an eighty-acre tract in 1948 and purchased two additional adjacent tracts in 1949 and 1950. During the period 1948-1951, the partnership built and sold approximately five hundred homes on two of the tracts. It was not disputed that these properties were held primarily for sale. In late 1951, the partnership was incorporated. During the later part of 1951 and into 1952 the tract was developed and 194 duplex houses were built by corporations controlled by the taxpayer and his former partner. This development, which was to be operated as rental property, proved unsuccessful and in the period 1955 to 1958, 169 duplexes were sold. The taxpayer re-

²⁰ See *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 52 (1955), *rehearing denied*, 350 U.S. 943 (1956).

²¹ *Brown v. Commissioner*, 448 F.2d 514, 516 (10th Cir. 1971).

²² See text accompanying notes 9 & 21 *supra*.

²³ 382 F.2d 675 (9th Cir. 1967).

ported the profits as capital gain, and quite naturally, the Internal Revenue Service disagreed. The Court of Appeals for the Ninth Circuit, reversing a Tax Court decision holding that the property was "primarily for sale property," held that

where the facts clearly demonstrate that a taxpayer held certain property as an investment, and further show that this purpose continued until shortly before the time of a sale, and that sale is prompted by a liquidation intent, the taxpayer should not lose the benefits provided for by the capital gain provisions.²⁴

The court felt that the building and rental of the duplexes was an entirely new business venture which must be distinguished from his building and sales activities on the first two tracts. Investment in rental property must be distinguished from subdivision and sale. The court apparently believed that since this was rental property—an investment—until shortly before the sale of the duplexes, the decision to sell reflected an intent to terminate an investment and not an intent to convert the property into the same inventory-like assets found on the first two tracts.

In its opinion, the *Heller* court favorably cited the Eighth Circuit's decision in *Municipal Bond Corp. v. Commissioner*²⁵ as support for its acceptance of the liquidation theory.²⁶ The court in *Municipal Bond Corp.* was reviewing a factual determination of the Tax Court²⁷ that certain real property sales resulted in ordinary income. Noting that the Tax Court had limited its consideration of the taxpayer's primary purpose to the time of the sale,²⁸ the court of appeals stated that the purpose for which the property was acquired and the purpose for which it was held must also be taken into account.²⁹ The court thus implied that "primary" should be viewed in the context of the entire period of ownership and not merely at or about the time of decision to dispose of the property. This implication is strengthened by the court's quotation of language used in another Eighth Circuit decision:

In *United States v. Cook*, 8 Cir., 270 F.2d 725, 729, . . . we said: "There is no requirement in the statute that the property be used in the trade or business of the taxpayer right up to and including the date of sale or exchange. The statute contemplates and the

²⁴ *Id.* at 680.

²⁵ 341 F.2d 683 (8th Cir. 1965).

²⁶ 382 F.2d at 680.

²⁷ 41 T.C. 20 (1963).

²⁸ *See id.* at 28.

²⁹ 341 F.2d at 689.

regulations provide for a reasonable time for disposition after the necessary termination of the property's intended use."³⁰

That the liquidation theory has become established as a method of achieving capital gain was acknowledged by the Tax Court in a decision holding that the taxpayers had not come within this exception. In *S.O. Bynum*,³¹ the court stated:

Petitioners' position, of course, is that they were simply passive investors engaged in liquidating a portion of their farm to their best advantage in order to satisfy their mortgage, *after having ascertained that on a single sale of the entire property they would have realized less than the existing mortgage.*³²

The court did not disagree with the theory underlying the taxpayers' position but rejected it "since we believe it is not supported by the facts."³³ It was noted that the taxpayers had (1) incurred substantial subdivision costs, including expenses for streets, water, sewerage, drainage and the like; (2) advertised the subdivided lots extensively; and (3) in fact negotiated for and sold each lot themselves.³⁴ These were characteristics not of a person with a liquidation of investment intent but rather of a person who was

actively engaged in a . . . business — that of selling subdivided lots . . . and that such property was then held by petitioners primarily and principally for sale to customers in the ordinary course of that business, and that this purpose was of first importance to petitioners.³⁵

A reading of *Heller, Municipal Bond Corp.* and *S.O. Bynum* leads to the following basic conclusions. First, a taxpayer who purchases investment property and holds it for a substantial period of time is permitted to sell that property to take into account the "realization of appreciation in value accrued over a substantial period of time."³⁶ Second, it is not necessary that this liquidation or termination of investment be consummated at less than the most favorable price,³⁷ or in a single sale of the property.³⁸ Finally, it is necessary that the taxpayer's activities in readying the property for sale be limited to a level

³⁰ *Id.*

³¹ 46 T.C. 295 (1966).

³² *Id.* at 299 (emphasis added).

³³ *Id.* at 299.

³⁴ *Id.* at 297-98.

³⁵ *Id.* at 300.

³⁶ *Commissioner v. Gillette Motor Co.*, 364 U.S. 130, 134 (1960).

³⁷ *S.O. Bynum*, 46 T.C. 295, 299 (1966).

³⁸ *Municipal Bond Corp. v. Commissioner*, 341 F.2d 683 (8th Cir. 1965).

far below that which would equate him with one who is in the business of selling and who holds his property primarily for sale to customers in the ordinary course of that business.³⁹ Applying these general propositions to condominiums, one commentator⁴⁰ has developed the following list of factors relevant to application of the liquidation of investment theory:

- (1) the owner demonstrates that his efforts to sell the building to a single purchaser have been unsuccessful;
- (2) the owner engages in no selling activity but rather hires an independent agent to merchandise the units;
- (3) the tenants have previously requested that the owner convert and sell;
- (4) the owner avoids making extensive improvements in connection with the sale of the units;
- (5) the owner has maintained his investment in the building for a substantial period of time prior to conversion and sale; and
- (6) the proceeds of the sales are not reinvested in real estate or real estate business.

Applying these tests to the conversion and sale of the hypothetical Plancourt units, the liquidation of investment approach would probably be unavailable unless the partnership eliminated from its plan the increase in maintenance and security forces, the use of a wholly-owned corporation as sales and advertising agent and the substantial renovations of electrical systems, landscaping and building exteriors.

Use of an Independent, Nonrelated Middleman

As previously discussed,⁴¹ capital gain treatment will result if the transaction involved merely represents the realization of appreciation in value of property which has been held for a substantial period of time.⁴² An outright sale of Plancourt would meet this test. This securing of capital gain treatment, however, brings with it a probable reduction in total profit since the maximization of gain usually available on a sale of units is surrendered. Consequently, the question arises as to whether a route can be taken which combines a lessened risk of ordinary income with an increased profit potential. The use of an independent, nonrelated middleman may afford such an opportunity.

Basically, the transaction would be structured as follows: The XYZ

³⁹ S.O. Bynum, 46 T.C. 295 (1966).

⁴⁰ Shapiro, *Commercial Condominiums*, 41 J. TAX. 46, 47 (July 1974).

⁴¹ See text accompanying notes 13-14 *supra*.

⁴² For a treatment of sales to a related corporation or partnership, see Shapiro & Lemlech, *Tax Planning the Condominium Conversion—Analysis of Capital Gain Possibilities*, 1 J. REAL ESTATE TAX. 184 (Winter 1974).

Partnership would enter into an agreement with *A*, the purchaser, to sell Plancourt. *A* would be a person who wishes to immediately convert the apartment project into a condominium and to offer the units for sale. Consequently, the purchase price (payment of which typically would involve a non-recourse purchase money mortgage) would reflect this relatively immediate profit to the purchaser and would be somewhere between the entity price and the as-converted price. The pretax realization would be somewhat less than that otherwise available to the partnership. However, the possible availability of long-term capital gain treatment could more than offset this loss.

As might be expected, there are several pitfalls which must be avoided if the attempt to realize capital gains treatment is to have a reasonable possibility of success. There is the possibility that *A* and the XYZ Real Estate Partnership will be viewed as joint venturers⁴³ or that the XYZ Real Estate Partnership will be viewed as having held the property "primarily for sale" at the time it was offered to *A*.⁴⁴

To minimize this joint venture problem, the XYZ Real Estate Partnership must actually "sell" the project, and *A* must actually "buy" the project. Hence, one hundred percent financing by the partnership is fatal. *A* must make a substantial investment of his own and therefore expose himself to a substantial risk of loss. Additionally, even though it has taken back a purchase money mortgage (either recourse or non-recourse), the partnership should not involve itself *to any degree* with either the sales activities or management activities of *A*. *A* must own the property in substance as well as in form. *A* must arrange for advertising, renovation, repair, sales force, counsel, and the like. The partnership's sole remaining involvement with Plancourt should be merely as obligee on the purchase money mortgage.

The second problem involved in the use of a middleman stems not from post-sale activities but rather from the record made by the partnership prior to its involvement with *A*. In fact, this involves the question of what kind of property was the project when a middleman first entered the picture. Was the project held as an investment or was it held for sale to customers in the ordinary course of the partnership's trade or business? Consequently, the same questions must be asked and the same guides applied as are involved in the dealer versus

⁴³ Under section 761(a) of the 1954 Code, such association would be a partnership for purposes of federal income taxation. Consequently, if *A* and the XYZ Real Estate Partnership were viewed as a joint venture, the realized gain on sale of the units would probably be ordinary income.

⁴⁴ See discussion of the term "primarily for sale" in text accompanying notes 5-12 *supra*.

investor inquiry.⁴⁵ Clearly, the partnership should not have (1) prepared and/or filed a plan for converting the project into a condominium; (2) contracted for or undertaken substantial renovation or improvement activities; (3) increased security or maintenance staffs; (4) advertised the potential conversion; (5) established any condominium sales force or undertaken any condominium sales activities; or (6) committed itself to or undertaken any other activity which would cause the property's sale to A to be viewed as other than a mere "realization of appreciation in value accrued over a substantial period of time."⁴⁶

Conclusion

It is quite likely that any attempt by the XYZ Real Estate Partnership to achieve capital gain treatment in a transaction other than an outright sale of the project as an entity will be subject to challenge by the Internal Revenue Service. Consequently, the more the form and substance of the sale resemble the termination of an investment, *i.e.*, the realization of appreciation accrued over a substantial period of time, the more likely is it that the Service's challenge will fail. Similarly, if the conversion of the project and the sale of units constitutes more than a realization of appreciation, *i.e.*, more than a relatively passive liquidation of investment, the Service will probably be successful in its attempt to treat the profits as if they arose from the everyday operations of a business.

FEDERAL INCOME TAX CONSEQUENCES OF UNIT OWNERSHIP

Condominium Unit Used as Personal Residence

The purchase of a condominium unit is the purchase of real property. If the condominium unit is used by the owner as his personal residence, he will be entitled to take certain itemized personal deductions.⁴⁷ Real property taxes assessed against the unit ownership⁴⁸ and interest paid on any mortgage liability against the unit⁴⁹ are fully deductible by the condominium unit owner. Unreimbursed fire, storm or other casualty losses suffered with respect to the unit are deductible to the extent that such losses exceed \$100.⁵⁰ Similarly, property taxes

⁴⁵ See text accompanying notes 13-21 *supra*.

⁴⁶ *Commissioner v. Gillette Motor Co.*, 364 U.S. 130, 134 (1960).

⁴⁷ As in the case generally of personal deductions, the taxpayer must elect between itemizing them or taking the optional standard deduction. INT. REV. CODE of 1954, § 144.

⁴⁸ INT. REV. CODE of 1954, § 164; Rev. Rul. 64-31, 1964-1 CUM. BULL. 300.

⁴⁹ INT. REV. CODE of 1954, § 163.

⁵⁰ INT. REV. CODE of 1954, § 165(c).

assessed against the underlying land and common areas are deductible in accordance with the proration of those taxes among the unit owners. Interest paid on a mortgage liability against the land and common areas will similarly be prorated. A casualty loss, such as fire damage, to the common areas would also be prorated among the unit owners and each would be entitled to deduct his share.

Two exceptions to the general availability of these deductions must be noted. First, if the common areas are incorporated, the taxes, interest and casualty loss deductions will be those of the corporation, not of the unit owners.⁵¹ Second, if the land is leased, rather than purchased, the amounts paid by the unit owners as ground rent to the landowner are nondeductible personal rentals. Moreover, the landowner receives the benefit of the property tax deductions and any mortgage interest attributable to the land.⁵²

If the condominium unit is used as the owner's principal residence, he is entitled to home owner benefits when he disposes of the unit. Any realized gain is capital in nature. He may also defer the tax on the gain realized by purchasing a new principal place of residence in accordance with the requirements of section 1034 of the Code.⁵³ The new principal residence may be another condominium unit, a single family residence, or stock in a qualified cooperative housing project.⁵⁴ If the owner of a condominium unit is older than 65 at the date of the sale and has used the unit as his principal residence for periods aggregating at least five of the eight years immediately prior to the sale, then he may be entitled to exclude from income all or a part of the gain realized on a sale of the property even though he does not buy a new residence.⁵⁵ The amount of the gain excluded from tax by

⁵¹ Contributions to the corporation to reimburse it for the tax, interest or casualty deductions are not deductible by the unit owners unless the unit owners incur these expenses themselves. Only the corporation may properly take the deductions. See discussion of nonprofit corporations in text accompanying notes 75 & 76 *infra*.

⁵² The leasehold condominium is a common occurrence in Hawaii and occurs with some frequency in California.

⁵³ The three main requirements of section 1034 are (1) that the property sold has actually been used by the owner as his principal residence; (2) that a new principal residence has been or is acquired within one year of the date of sale (18 months if the new residence is constructed); and (3) that the cost of the new residence equals or exceeds the adjusted sales price of the old residence. If the adjusted sales price of the old residence exceeds the cost of acquiring the new residence, gain is recognized to the extent of such difference. For purposes of section 1034, "adjusted sales price" is defined as "the amount realized, reduced by the aggregate of the expenses for work performed on the old residence in order to assist in its sale." INT. REV. CODE OF 1954, § 1034(b)(1).

⁵⁴ Treas. Reg. § 1.1034-1(c)(3) (1970).

⁵⁵ INT. REV. CODE OF 1954, § 121. This provision is elective, but in any case no more than one election can be in effect at the same time. *Id.* § 121(b)(2). The taxpayer must have actually reached the age of 65 prior to the sale before the section will apply. Rev. Rul. 68-210, 1968-1 CUM. BULL. 61.

a person over 65 is determined as follows: (1) If the adjusted sales price is \$20,000 or less, all of the gain may be excluded; (2) if the adjusted sales price is more than \$20,000, the owner may exclude from income that amount of the gain that bears the same percentage relationship to the total gain as \$20,000 bears to the adjusted sales price.⁵⁶

It should also be noted that where the condominium unit is used as a principal place of residence and is condemned, or sold under the threat or imminence of condemnation, the owner has a choice of using the benefits of section 1034, or treating the sale as an involuntary conversion to which section 1033 applies.⁵⁷ Under the latter section, the owner may defer any gain realized on the conversion sale by purchasing another principal residence within the two taxable years following the close of the taxable year in which the condemnation sale occurred.⁵⁸

The federal gift and estate tax consequences of unit ownership are identical to those of the homeowner. If the owner is married, he may take title to the property in the joint names of himself and his wife without incurring any immediate federal gift tax liability.⁵⁹ Section 2515, which provides the foregoing exception to the application of federal gift tax, applies only to the creation of "tenancies by the entirety" in real property.⁶⁰ By statute, the term "tenancy by the entirety" includes a husband-wife joint tenancy with a right of survivorship.⁶¹ The fact that one spouse has paid the full purchase price out of his separate funds is immaterial, unless he elects to report a gift by filing a gift tax return.⁶² If the election is not made, federal gift tax liability is not incurred until the tenancy is severed. If severed by the death of the husband, the full value of the property is includible in the husband's gross estate for federal estate tax purposes. If severed

⁵⁶ INT. REV. CODE of 1954, § 121(b)(1).

⁵⁷ INT. REV. CODE of 1954, § 1034(i)(2). Which section should you choose? Section 1034 permits a reduction of the sales price for "fixing-up" expenses within 90 days of the sales contract. But the period of acquisition is 12 months (18 months if a new residence is being constructed). Section 1033 has a two year post-year-of-condemnation period, but it does not permit "fixing-up" expenses either to reduce the sales price or to be added to basis. Consequently, if a taxpayer wishes to reduce the sales price by his last 3 months gardening expense, painting expense, and the like, he would elect section 1034. If he desires to postpone a reinvestment decision for 2 years, he would elect section 1033. However, the election cannot be made in the case of "destruction" of the property. Treas. Reg. § 1.1034-1(h)(2)(ii) (1970). In such a case, section 1033 would automatically apply.

⁵⁸ Section 1033 requires that property which is not held "for productive use in trade or business or for investment," be replaced with property that is "similar or related in service or use." That language requires the owner to acquire another residence that will be used in the same manner as the old residence.

⁵⁹ INT. REV. CODE of 1954, § 2515.

⁶⁰ *Id.* § 2515(a).

⁶¹ *Id.* § 2515(d).

⁶² *Id.* § 2515(a). By election under section 2515(c) the creation of the tenancy becomes a transfer subject to the gift tax.

by the death of the wife, the value of the property is excluded from the wife's gross estate since it is assumed that the full purchase price came from the husband. If severed during the lifetime of both husband and wife, a gift, subject to possible federal gift taxes, will be made to the extent that the wife receives any of the property, or interest therein, at the time of the severance.⁶³

Finally, since the condominium unit used for residential purposes is a capital asset, any loss realized on its sale is nondeductible because the property was acquired for personal and not business or profit purposes.⁶⁴ Similarly, the unit owner may not take a deduction where the property was condemned since a condemnation taking is treated as a sale and not as a "casualty."

Condominium Units Held for Business Use

Where the condominium unit is used by a taxpayer for conducting a trade, business, or practicing a profession, real property taxes, interest expenses and casualty losses may be deducted whether or not the taxpayer takes the optional standard deduction in lieu of itemizing his personal deductions.⁶⁵ Other trade or business expenses, such as the cost of property insurance, repair and maintenance expenses, may also be deducted.⁶⁶ In addition, the taxpayer will be entitled to deduct a reasonable allowance for depreciation. This includes accelerated depreciation of new construction not in excess of one hundred and fifty percent of straight line depreciation on a declining balance method.⁶⁷ If the condominium unit is rented to others for their personal residential purposes and the unit is new construction in the hands of the owner, the deduction is liberalized to include such accelerated methods of depreciation as sum-of-the years digits and two hundred percent declining balance (double declining balance).⁶⁸

Assuming the condominium unit is rented to others, whether for their residential use or for their use in a trade or business (including

⁶³ *Id.* § 2515(b).

⁶⁴ *Id.* §§ 165(c), 262.

⁶⁵ *Id.* §§ 163-165. These are so-called "above the line" deductions, that is, deductions from gross income in order to determine "adjusted gross income." If a charitable deduction is important, a higher "adjusted gross income" is significant since it raises the potentially deductible dollar amount which is limited to 50% of the "adjusted gross income" figure. *Id.* § 170(b)(1)(F).

⁶⁶ *Id.* § 162.

⁶⁷ *Id.* § 167. The annual excess of accelerated over straight line depreciation is an item of tax preference income which may be subject to the penalty tax imposed by section 57 of the Code. No corresponding tax benefit, such as an adjustment to basis or a credit against recapture exposure, is granted the taxpayer.

⁶⁸ *Id.* § 167(j). The annual excess is an item of tax preference income that may be subject to the tax imposed by section 57 of the Code.

the practice of a profession), a limitation on the deduction of interest expense will be imposed if the rental terms are such that the relationship is a "net lease."⁶⁹ In such case, interest expense is deductible in full up to a limited amount and thereafter only to the extent of fifty percent.⁷⁰ This limitation on the deduction of investment interest is not on a "per project" basis but rather is a limitation on the aggregate amount of investment interest.

If the condominium unit has been held for more than six months and is used by the owner in his own trade or business (including the practice of a profession), or is rented to others, it constitutes section 1231 property, *i.e.*, property used in the taxpayer's trade or business. Under section 1231 of the Code, any gain or loss realized on the sale of the unit must be aggregated with other section 1231 gains and losses.⁷¹ Any gain resulting from the 1231 netting computation will be taxed as a long-term capital gain; while a resulting loss will be deductible as an ordinary loss.⁷² Conversely, where the owner used the unit in his trade or business or rented it but held it for six months or less, section 1231 is inapplicable and any gain or loss realized on disposition will be either ordinary income or ordinary loss.⁷³

There may be one exception to the foregoing conclusions. Property rented on a "net lease" basis, within the meaning of the section 163 limitation on the deduction of investment interest, should probably be treated as an investment asset rather than a section 1231 trade or business asset. Consequently as an investment or capital asset, gains or losses will be capital gains or losses not subject to section 1231 netting. Treatment of "net lease" rental property as a capital asset would be beneficial only when a gain is realized on the unit's disposition. The benefit is due to the fact that any gain would not be used to offset section 1231 losses for the year. Thus, the probability that the

⁶⁹ Section 163(d)(4) of the Code defines a "net lease" as a lease of property where for the taxable year in question

(i) . . . the sum of the deductions of the lessor with respect to such property which are allowable solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) is less than 15 percent of the rental income produced by such property, or

(ii) the lessor is either guaranteed a specified return or is guaranteed in whole or part against loss of income.

⁷⁰ *Id.* § 163(d). The owner of investment property, including property rented on a "net lease" basis can deduct investment interest (that is interest paid on obligations to acquire or retain investment property) in full to the extent of \$25,000 plus net investment income plus capital gains (note, however, that the latter then becomes fully taxable). The excess is deductible only to the extent of one-half.

⁷¹ *Id.* § 1231(a).

⁷² *Id.*

⁷³ See P.E. ANDERSON, *TAX FACTORS IN REAL ESTATE OPERATIONS* 89 (3d ed. 1969) [hereinafter cited as ANDERSON].

netting process will result in a loss—and ordinary deductions for each 1231 asset—is substantially increased. In the case of a loss, however, treatment of “net lease” rental property as an investment asset would be disastrous. Such a loss would be treated as a capital loss, deductible only against capital gains (including net section 1231 gains) and, only to the extent of fifty percent, or \$2,000, of the loss, whichever is less, against \$1,000 of the seller's ordinary income.⁷⁴

TAX ASPECTS OF CONDOMINIUM MANAGEMENT AGREEMENTS

Condominium unit owners may enter into an agreement providing for some or all of the following matters: (1) maintenance of the exterior and all internal common spaces; (2) employment of management staff and other personnel (or making contractual arrangements therefor) such as security, janitorial, gardening, repair, T.V. cable, and other services; (3) arrangements for supplying and payment of heat, light, water, power, and other utilities; (4) management and operation of recreational facilities, such as swimming pools, tennis courts, golf courses, spas, muscle gyms, saunas, and recreational rooms; and (5) rules of personal conduct applicable to mutual owners living in close proximity, relating to noise, smells, lights, conduct of a business or professional practice at home, advertising, and the like.

Management Caretaking and Servicing Agreements Among Condominium Owners

Contracts among owners of condominium units for the employment of people to manage, maintain, and otherwise provide necessary services for the units and common areas create no major tax problems. In the case of wholly residential condominiums such expenses are nondeductible. If the condominium is wholly commercial (for example, a medical-dental building) the expenses are deductible.

Recreational Facilities

The cost of mutually agreed upon operation of recreational facilities and other common areas, represented by property taxes, mortgage interest and casualty losses, are deductible. Maintenance expenses and the like are not. However, the exposure to possible nontax liabilities frequently pressures the unit owners to transfer the common areas and the recreational facilities to a nonprofit corporation. By doing so the unit owners hope to limit their liability to their investment. However, such a move results in an adverse tax consequence because the property

⁷⁴ INT. REV. CODE OF 1954, § 1211(b).

tax, interest and casualty deductions attributable to the property conveyed are similarly transferred to the nonprofit corporation.⁷⁵

Another potential tax problem may arise where such ownership is conveyed to a nonprofit corporation. The conveyance of the property to such a corporation is tax-free under section 351 of the Code unless the basis allocable thereto is less than the mortgage indebtedness against the property transferred. If the assumed mortgage debt exceeds allocable basis, a gain — to the extent of the excess — will be recognized.⁷⁶

The operation of the recreational facilities of the condominium by a nonprofit corporation should result in no adverse tax consequences. Assuming the corporation operates at a loss, such loss is not deductible by the shareholders. Moreover, if the corporation operates at a gain, such gain should be nontaxable if the corporation can qualify for an exemption as a section 501(c)(7) recreational club.⁷⁷ Another more difficult problem is presented by the recently promulgated Revenue Ruling 74-17,⁷⁸ wherein the Service ruled that reserves of a condominium association which exceed expenses constitute profits. Since the Ruling further provides that a condominium association is not tax-exempt under section 501(c)(4), it is extremely important that the incorporated recreational facilities are tax exempt under section 501(c)(7).

Rental of Space to Outsiders

Rental transactions give rise to the most serious tax problem facing condominium owners whether they participate in a residential or commercial condominium. The problem is a simple one: will the net rentals be taxed to an association of owners⁷⁹ as a corporation? If so, the

⁷⁵ In order to avoid this transfer of otherwise deductible items, the unit owners could retain title to the recreational facilities and other common areas and purchase a landlord's liability insurance policy. The unit owners could then lease the property to a nonprofit corporation on a net lease basis. In this manner, they would retain the deductible items and the nonprofit corporation would absorb nondeductible insurance and maintenance costs. The only significant tax problem caused by this approach is the limitations on deductibility of "investment interest" provided by section 163 of the Code.

⁷⁶ INT. REV. CODE OF 1954, § 357(c).

⁷⁷ *Id.* § 501(c)(7). This section provides an exemption from taxation for "[c]lubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes . . ." It has recently been ruled that section 501(c)(4), social welfare leagues, does not exempt a condominium association from federal income taxes. Rev. Rul. 74-17, 1974 INT. REV. BULL. NO. 2, at 11. If recreational facilities are made available to nonmembers (nonshareholders) for a fee, the corporation may lose its exemption.

Social clubs frequently have this problem. Mr. Anderson has been advised that if reported receipts from nonmembers exceed 20% of the exempt club's gross income, the social club's exemption will be revoked.

⁷⁸ 1974 INT. REV. BULL. NO. 2, at 11.

⁷⁹ INT. REV. CODE OF 1954, § 7701.

net income will be subject to double taxation. It will be taxed first to the condominium association and then to the owners on distribution of the net amount after the corporate tax.

The condominium owners who rent their units usually do so through a manager who is under a written contract with the owners. Generally, the manager is empowered to sign a lease for the owner on the best terms and conditions that can be arranged. The question arises as to whether the foregoing arrangement constitutes an association taxable as a corporation. Section 301.7701-2 of the Treasury Regulations sets forth the factors to be considered in determining whether a particular business venture is to be viewed as an association taxable as a corporation. The Regulations require an association of persons, a purpose to engage in business, continuity of life, centralization of management, limited liability, and free transferability of interests.⁸⁰ For the purpose of this analysis, a profit motive among the unit owners must be assumed. That is, the unit owners decide that part of the property should be rented out at a profit, but the unit owners do not incorporate. What result?

Since concededly there are persons who have associated for a profit-making purpose in order to avoid corporate status, the unit owners must negate at least two of the four common characteristics of a corporation: continuity, transferability, limited liability and centralized management.⁸¹

A. Continuity of Life

No one condominium owner can normally sue for partition, except in the case of destruction in whole or in major part. A condominium is treated under the income tax law as much a product of contractual agreement as it is a conveyance of land. Therefore, in the absence of contrary agreement, death, insanity, or bankruptcy of any member is *not* considered adequate to destroy the "continuity of life" of the association. This is a corporate characteristic. In a partnership, any one partner can cause a dissolution under the Uniform Partnership Act. In a tenancy in common, any one tenant can normally seek partition.

How can this corporate characteristic be negated? It would seem that if the agreement provided for expulsion of a unit owner for cause with a right on the part of the expelled owner to (1) receive the fair market value of his unit, or (2) sue for partition, continuity of life

⁸⁰ Treas. Reg. § 301.7701-2 (1965).

⁸¹ *Id.* § 301.7701-2(a)(3).

would not exist.⁸² The fact that such right would rarely, if ever, be exercised because of its rather drastic consequences seems to be immaterial under the Treasury Regulations.⁸³

B. Centralization of Management

The essential inquiry regarding centralization of management is "who makes the decisions?" If the approval and consent of *all* condominium owners is required there is no centralized management. On the other hand, if a group of *less than all* of the owners has exclusive authority to make all decisions for the business, centralized management is present.⁸⁴

A board of managers would probably meet the test of centralized management if it made all the business decisions. Business decisions are of two basic kinds. For lack of a better expression, they can be classified as "day-to-day" ministerial decisions and "policy" decisions. If all "policy" questions are decided by the entire membership, ministerial decisions can be delegated to a manager (or board of managers) as agent without fear of a finding of centralized management.⁸⁵

The question therefore becomes what are "policy" decisions and what are ministerial decisions. "Day-to-day" decisions are those that relate to the choice of garbage collectors, gardeners, office procedures, and similar matters. All other decisions, such as the rent to be charged, the term of the lease, and the use of the space should be voted on by the condominium owners either before the execution of the lease or in ratification thereof. If the vote is taken in ratification of the lease, the manager should be careful to make the lease contingent upon such ratification. Normally, neither the contingency nor the ratification is a problem in arranging a lease.

The more limited the authority of the board of managers, the less the risk of being viewed as an association taxable as a corporation.

C. Limited Liability

Despite the fact that the unit owners have formed an association, the available authorities maintain they remain jointly and severally liable for torts arising from use of the commonly owned property.⁸⁶

⁸² See *id.* § 301.7701-2(b)(3). The language of the Regulation is simple: "[I]f the death, insanity, bankruptcy, retirement, resignation, or *expulsion* of any member will cause a dissolution of the organization, continuity of life does *not* exist" (emphasis added).

⁸³ *Id.*

⁸⁴ *Id.* § 301.7701-2(c).

⁸⁵ *Id.* § 301.7701-2(c)(3).

⁸⁶ See Rohan, *Perfecting the Condominium as a Housing Tool: Innovations in Tort Liability and Insurance*, 32 LAW & CONTEMP. PROB. 305, 308 (1967); Schreiber, *The Lateral*

The fact that the owner participates in insurance coverage to indemnify himself would not alter such a conclusion. Thus, the corporate characteristic of limited personal liability would appear to be absent.⁸⁷

D. Transferable Interests

Condominium ownership can be established with restricted or unrestricted freedom of transfer. If totally restricted, the corporate characteristic of freely transferable interests is absent.⁸⁸

There are several partial or limited restrictions on transferability. One is a mutual buy-sell agreement under the terms of which each owner agrees that he will sell to his co-tenants at a fixed price in the event he decides to sell. Another is to condition any sale upon the consent of a majority of the owner's co-tenants. Each of these has the economic objection that the owner is subjecting a valuable investment either to a ceiling in price appreciation or to the whim of his co-tenants. A right of first refusal may satisfy these objections. That is, the other co-tenants have a first right to buy a prospective seller's condominium unit on the same terms and conditions as he may negotiate with an outsider. If none of the co-tenants wants to buy at that price, the owner is free to sell to the outsider.

The Treasury Regulations equivocate on the effect of a right of first refusal. Such a right is not sufficient of itself to make the interests not freely transferable. The Regulations state that in such a case transferability exists only in modified form.⁸⁹ Whether the test of "free" transferability is or is not met or whether such "modified" transferability is a corporate characteristic has not been answered by the Treasury. The Treasury has stated that if "modified transferability" exists, the corporate characteristic of free transferability has *less* significance in determining whether or not the group is an association taxable as a corporation.⁹⁰

A way to avoid the problem is to provide that no unit owner can sell his interest without first obtaining the consent of the board of managers. If the board has absolute discretion to refuse consent, there would appear to be no free transferability.

Housing Development: Condominium or Home Owners Association?, 117 U. PA. L. REV. 1104, 1143-45 (1969).

Some states, however, have provided by statute that unit owners shall have no personal liability for actions of the association or for torts arising from the use of the common elements. *See, e.g.*, ALASKA COMP. LAWS ANN. § 34.07.260 (Supp. 1971); FLA. STAT. ANN. § 711.18(2) (1969); WASH. REV. CODE ANN. § 64.32.240 (1966).

⁸⁷ *See* Treas. Reg. § 301.7701-2(d) (1965).

⁸⁸ *Id.* § 301.7701-2(e).

⁸⁹ *Id.* § 301.7701-2(e)(2).

⁹⁰ *Id.*

Thus, of the six corporate characteristics thought important by the Treasury, two are normally present in a condominium association agreement to rent out commonly owned property at a profit, *viz.*, associates and a shared profit motive. It may be possible to avoid the other four characteristics.

Tax Consequences of Corporate Treatment of a Condominium Association

A. Ownership of Individual Units

Because the individual condominium units are not held for a common profit, the gross income and deductions allocable thereto cannot be treated as part of the gross income or deductions of the condominium association. Nor would co-tenancy assessments for nonbusiness purposes, such as the maintenance of recreational facilities, be attributed to the condominium association.

It is recommended that the practitioner sever agreements for the use and occupancy of individually owned space and for the maintenance and care of non-income producing common space from agreements relating to commonly-owned income producing space. Such separation should not be essential for the separate tax treatment of the latter, but advisable to avoid third-party confusion as to the extent of the *common* profit-making activities of the co-owners.

B. Co-ownership of Common Rental Property

If more corporate characteristics are present than not in the group agreement to operate commonly owned rental property leased out to nonowners, the group agreement will constitute an association taxable as a corporation. This treatment must be limited to commonly owned property (whether held for profit or nonprofit purposes). As individual unit owners, the taxpayers are acting independently of one another if each rents out his own unit for business purposes. In such a case, unit owners are not acting in concert and cannot be "associates."⁹¹ Nor can it include commonly owned property held for non-income purposes (elevators, lobbies, hallways, garbage areas, and the like, servicing residential units, recreational areas, and similar properties) because even though the common owners are associated, this association is not for a profit.

The tax consequences of treating the commonly held rental property of condominium owners as being held by an association taxable

⁹¹ *Id.* § 301.7701-2(a)(1)(i), (ii).

as a corporation are disastrous. None of the condominium owners would be entitled to deduct his aliquot portion of the interest, taxes, or depreciation allocable thereto; all of these deductions would be allocated to the corporate association. The rental income received would be taxed to the corporate association at corporate tax rates to the extent it exceeded allocable deductions. Finally, the use of any funds of the corporate association to pay expenses properly allocable to the individual condominium unit owner would be considered a dividend to them which would be taxable as ordinary income to the extent of the association's current and accumulated earnings and profits.⁹²

Nor would the Code provisions dealing with cooperative housing corporations be of help unless the outside gross rental income is less than twenty percent of the condominium association's gross income.⁹³ While the term cooperative housing corporation is broad enough to cover a condominium association taxable as a corporation,⁹⁴ the restrictive provisions on gross income would apply. Eighty percent or more of the cooperative housing corporation's gross income must be derived from its owners.⁹⁵ For this purpose, amounts paid by tenant-stockholders to the cooperative housing corporation to meet mortgage or other lien payments are not part of the corporation's gross income; such amounts are contributions to the corporation's capital.⁹⁶ As a consequence, the amount of nonqualified income from outside sources will normally exceed twenty percent of total gross income.

If the condominium owners cannot avoid tax treatment as an association taxable as a corporation, they should consider the alternative of incorporating for the purpose of renting out the commonly owned rental space. The property to be so rented should not be transferred to the rental corporation. It should be retained by the co-owners and leased to the corporation. Each co-owner should individually sign the lease as a tenant in common in order to preserve his status as an individual owner. The corporation should be organized with a minimal amount of cash, and should then enter into a lease of the rental space from the condominium owners at a rental measured by the maximum

⁹² INT. REV. CODE of 1954, §§ 316, 301(c).

⁹³ *Id.* § 216. This section permits a pass through to shareholders of (1) interest, (2) property taxes, and (3) depreciation to the extent the shareholder uses the property for trade or business or other profit purposes.

⁹⁴ *Id.* § 7701(3). The corporation must have only one class of stock, each shareholder must have the right to occupy a unit, or no shareholder is entitled to any distribution of earnings except on liquidation. *Id.* § 216(b)(1).

⁹⁵ *Id.* § 216(b)(1)(D).

⁹⁶ Cambridge Apartment Bldg. Corp., 44 B.T.A. 617 (1941), *acquiesced in*, 1942-2 CUM. BULL. 2; 874 Park Avenue Corp., 23 B.T.A. 400 (1931), *acquiesced in*, X-2 CUM. BULL. 21 (1931).

fair rental allowable to the owners. By this arrangement the owners will receive their deductions for interest, taxes and depreciation because they are the owners of the commonly owned rental space. The corporate lessee should then be able to rent out the quarters on a sub-lease basis and take a deduction for rentals paid to the condominium unit owners.⁹⁷ While these rentals will be taxable to the co-owners, they will not be taxed both to the rental corporation and to the co-owners.

CONCLUSION

Condominium ownership gives a taxpayer all of the advantages of direct ownership of real property in terms of appreciation in value and deductibility of expenses. The problems of "association" status, loss of certain deductions and potential dividend treatment can be avoided if the draftsman of the condominium agreements exercises due care. Finally, and this must be emphasized, the tax implications of a proposed conversion and sale of a condominium should not be permitted to blind the lawyer to the non-tax needs of his clients. While concern for the tax implications of a proposed transaction is important, it cannot constitute the sole criterion for making or not making a particular business decision.

⁹⁷ ANDERSON, *supra* note 73, at 97-98.