Condominium: A Reconciliation of Competing Interests?

James C. Clark

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NOTES

Condominium: A Reconciliation of Competing Interests?

I. INTRODUCTION

As Americans have migrated to urban areas, the suburbs have grown at an astounding pace, principally by means of single home subdivisions. Of necessity, this march to the suburbs must cease at some point and people will begin to return to the central city and its close-lying peripheral areas if for no other reason than to lessen the heavy economic burden resulting from man-hours wasted in commuting great distances. Often the alternative to the suburban home is an apartment in the city. Apartment renting, however, runs counter to a deeply ingrained American tradition of individual home ownership, a tradition encouraged by favorable tax consequences.1 It seems only

1. The homeowner may deduct state and local, and foreign real property taxes, INT. REV. CODE OF 1954, § 164(a)(1); and mortgage interest charges, INT. REV. CODE of 1954, § 163(a). In addition, there is a provision for the nonrecognition of gain on the sale or exchange of the residence. INT. REV. CODE of 1954, § 1034. However, there is the ever present possibility that some or all of these tax advantages of the homeowner may be eliminated. Former Special Assistant Secretary of the Treasury, Dan T. Smith, has suggested “It would be preferable not to allow deductions for any taxes paid. . . . It would help remove the present discrimination in favor of homeowners who can deduct their property taxes, while renters have no deduction for any part of their rent.” Smith, New Ideas for a Revolution in Taxes, U.S. News & World Report, Jan. 18, 1960, p. 67. “The interest deduction gives a further benefit to homeowners with mortgages over renters. . . . The deduction might well be removed as part of a general reform.” Id. at 68. It has been suggested that property owners have no vested interest in the present deductions and that an investment in property should not be based solely upon expected tax deductions. 29 Mo. L. Rev. 338 (1964). However, even if the possibility of the elimination of this deduction exists, political realities would seem to militate against its elimination until the tradition of homeownership abates to a substantial degree.

An indirect tax advantage received by the homeowner is the tax free imputed income derived in the form of rent free use of the home. The value of the occupancy is not presently taxed as income. In fact, there is dictum that “the rental value of the building used by the owner does not constitute income within the meaning of the Sixteenth Amendment.” Helvering v. Independent Life Ins. Co., 292 U.S. 371, 379 (1934) (dictum). But if a renter invests an equivalent amount of wealth, he is subject to income tax on the income received.

Another advantage derived by the homeowner was expressed thusly: “Rent includes factors representing the costs of turnover in occupancy, such as loss of rents, renting commissions and redecorating. Comparable costs exist also in ownership but they are more within the control of the owner, due in part to the fact that owners take better care of property than renters do and make less frequent changes in location.” Kerr, Condominium—Statutory Implementation, 38 St. John’s L. Rev. 1, 11 (1963).

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natural that in this period of increasing urbanization the condominium concept should be advanced as an attempt to reconcile these needs. Its arrival on the property scene has attracted the intense interest of potential apartment dwellers, developers, and legal writers.  

Basically the condominium is a form of property ownership whereby the owner has fee simple title to a single unit within a multi-unit building with an undivided interest in the common elements—land, hallways, swimming pools, heating plants, et cetera.  

Condominium is a new form of ownership, not a new estate or different kind of property.  


3. The Florida Condominium Act contains the following definition: “Condominium is that form of ownership of condominium property under which units of improvements are subject to ownership by different owners, and there is appurtenant to each unit as part thereof an undivided share in the common elements.” Fla. Stat. Ann. § 711.03(7) (Supp. 1994).


5. 4 Powell, *Real Property* ¶ 633.1 (Boyer ed. 1964) [hereinafter cited as 4 Powell].

6. While condominium activity is relatively new in the United States, the concept itself was known to the ancient Romans. Berger, *Condominium: Shelter on a Statutory Foundation*, 63 Colum. L. Rev. 987 (1963). Separate ownership of portions of buildings was recognized in the Middle Ages in some cities in France. Leyser, supra note 2. “From Europe condominium went to Latin America, bypassing the continental United States when Puerto Rico passed an HPA.” [Horizontal Property Act—Title of some condominium acts] Kerr, supra note 1.
234 of the National Housing Act which permits the Federal Housing Administration to issue mortgage insurance on individual condominium units. While the section does not expressly cover condominiums, but rather, speaks in terms of "a one-family unit in a multifamily structure and an undivided interest in the common areas and facilities which serve the structure," it clearly was intended to cover the condominium. At the time of the passage of this amendment, only Puerto Rico had a condominium statute. In a period of less than four years, forty-four states and the District of Columbia have passed condominium legislation giving statutory basis to this form of ownership.

This note will first examine some of the operative provisions of the condominium statutes. Particular emphasis will be placed upon those provisions which are basic to the creation, existence, and dissolution of this unique form of property ownership. The FHA Model Statute For Creation of Apartment Ownership will be the principal vehicle of analysis, for it is the basis of many of the state condominium statutes. State provisions which differ from the Model Act will then be examined to discover the best statutory answer to the needs of condominium housing. Finally, attention will be focused on the tax implications of the condominium, principally from the developer's viewpoint. This will, of course, necessitate an examination of the functional problems that arise in tax planning.

II. NEED FOR PERMISSIVE LEGISLATION

While the present interest in the condominium has been created principally by the rapid spread of condominium legislation, it should be recognized that a condominium may be created by contract if the following conditions are allowed under state common or statutory law:

1. ownership of part of the building as an interest in land;
2. restraint against the partition of the commonly-owned land and partitions of the building;

12. [Hereinafter cited as the MODEL ACT.]
13. "The common law . . . never adopted a dogmatic attitude with regard to the existence of ownership rights over separate parts of a building. Such rights are mentioned in Coke on Littleton, and such 'superimposed freeholds' have existed in England in various places for a long time." Leyser, supra note 6, at 50-51.
(3) restraint against the separation of the share in the commonly-owned property from the separately-owned unit;

(4) separate assessment of units for taxation;

(5) provision for the use, management, and maintenance of the commonly-owned property; or, more briefly stated, provisions for operation of the condominium.\textsuperscript{14}

Obviously, it is difficult to find all of these conditions co-existing in a particular jurisdiction. However, a number of condominiums were constructed upon a common law framework in Florida, California, and Utah;\textsuperscript{15} but the circumstances of their creation may be unique in that each of these states subsequently passed condominium legislation.\textsuperscript{16} Perhaps these common law condominiums were partly inspired by the belief that such enabling legislation was imminent.

The absence of a condominium statute necessitates convincing all parties involved that the division of the air space above the land surface is practical and legal.\textsuperscript{17} The difficulty of guaranteeing that the listed conditions exist places a heavy burden on the developer and creates doubt as to the feasibility of the condominium without specific legislation. As one condominium observer noted: "Condominium, it appears, can exist under the common law, but whether it will flourish without statutory provision is doubtful."\textsuperscript{18}

Assuming the necessity for permissive legislation in order to give the certainty required by the real estate community and institutional lenders, what form should it take? Broadly speaking, a condominium statute must: (1) provide for the establishment of the condominium; (2) accommodate existing legislation dealing with recording procedures, taxation of property, liens, land-use control, to the unique requirements of the condominium; (3) provide a means of preserving unity and harmony of condominium projects by prohibiting suit for partition of the common areas; and (4) provide for the dissolution of the condominium.\textsuperscript{19} Subsequent discussion will examine in more detail the nature of some of these statutory prerequisites.

\section*{III. Creation of Condominium}

The condominium statutes, or horizontal property acts as they are

\begin{thebibliography}{9}
\bibitem{14} Supra note 4, at 2.
\bibitem{15} Berger, supra note 6.
\bibitem{16} CAL. CIV. CODE \S 1350-59; FLA. STAT. ANN. \S 711.01-23 (Supp. 1964); UTAH CODE ANN. \S 57-8-1 to 35 (1963).
\bibitem{17} Smith, supra note 2.
\bibitem{18} Berger, supra note 6.
\bibitem{19} 77 HARV. L. REV. 777 (1964).
\end{thebibliography}
sometimes called,\textsuperscript{20} prescribe the exclusive means whereby property may be submitted to their terms. The FHA Model Act provides: "The Act shall be applicable only to property, the sole owner or all of the owners of which submit the same to the provisions hereof by duly executing and recording a Declaration as hereinafter provided."\textsuperscript{21} While some of the acts vary in wording, the uniform requirement of filing a declaration removes any doubt as to whether a particular building has been submitted to the terms of the condominium act.\textsuperscript{22}

The declaration provides for descriptions of the land on which the condominium is constructed,\textsuperscript{23} the building,\textsuperscript{24} the individual apartments,\textsuperscript{25} the common elements,\textsuperscript{26} and the limited common elements and the unit to which they are appurtenant.\textsuperscript{27} It sets forth the value of the property and of each apartment and the percentage of the undivided interest in the common elements.\textsuperscript{28} The name of a person to receive service of process\textsuperscript{29} and the purposes for which the building and each apartment are intended and restricted\textsuperscript{30} as to use are likewise included in the declaration. Finally, the declaration may contain any further details as to the condominium which may be deemed desirable, including the method by which the declaration may be amended,\textsuperscript{31} so long as they are consistent with the enabling legislation.\textsuperscript{32}

Once the declaration has been filed and the building constructed, the question may arise whether a purchaser of an apartment takes an interest in real property. The Model Act provides specifically that each apartment together with its common elements "shall for all purposes constitute real property."\textsuperscript{33} Such an express provision seems preferable to those statutes\textsuperscript{34} which remain silent on this point, for it eliminates possible litigation and quells any fears of mortgage lenders created by the statutory void.\textsuperscript{35} But as noted in the next section, this precludes the creation of a condominium on a leasehold. If the legislature does

\begin{footnotes}
\item[21] Model Act § 3; N.Y. REAL PROP. LAW § 339-f.
\item[23] Model Act § 11 1.
\item[24] Model Act § 11 2.
\item[26] Model Act § 11 4.
\item[27] Model Act § 11 5.
\item[28] Model Act § 11 6.
\item[29] Model Act § 11 8.
\item[31] Model Act § 11 10.
\item[32] Model Act § 11 11.
\item[33] Model Act § 4.
\item[34] VA. CODE ANN. § 55-79.1-33 (Supp. 1964).
\item[35] Kenin, supra note 2, at 153.
\end{footnotes}
not deem such a restriction inconsistent with the condominium form of ownership, a proviso should be included to specifically permit the creation of a condominium on a leasehold, retaining the above provision to identify the interest where the regime is created on a fee simple absolute.

IV. LEASEHOLDS

The various condominium statutes are not uniform on the question of whether a condominium may be created on a leasehold. The FHA Model Act would seem to preclude the use of a leasehold interest in land, for it defines property as and including “the land, the building, all improvements and structures thereon, all owned in fee simple absolute.”\(^3\) It further defines an apartment owner as a “person or persons owning an apartment in fee simple absolute and an undivided interest in fee simple of the common areas and facilities.”\(^3\) An owner cannot have a fee simple absolute in his particular unit if the building is constructed on a leasehold.\(^3\) Therefore, statutes patterned after the FHA Model Act would preclude the construction of a condominium on a leasehold, regardless of its duration.

The same result would seem to be reached under the Florida statute. It defines a condominium parcel as a “separate parcel of real property, the ownership of which may be in fee simple, or any other estate in real property recognized by law.”\(^3\) The interest of a lessee is personal property, not real property.\(^4\) The Florida statute is an example of poor draftsmanship, for the authors of the act did not intend to preclude the creation of a condominium on a leasehold, considering this an undesirable interference with private property.\(^4\) However, the end product negated the creation of a condominium on a leasehold as effectively as if they had drawn the statute to expressly accomplish this result.

Other states have not restricted the condominium to a fee simple absolute as evidenced by the Virginia statute which specifically provides for the leasehold by stating, “‘Property’ means and includes the land whether leasehold or in fee simple and the building, all improvements and structures thereon and all easements, rights and appurtenances belonging thereto.”\(^3\) It is submitted that this is the preferable view, for there appears to be no legislative purpose served

\(^{36}\) Model Act § 2(m); N.Y. REAL PROP. LAW § 339-e(11) (Emphasis added.)
\(^{37}\) Model Act § 2(b). New York defines unit owner as the “person or persons owning an unit in fee simple absolute.” N.Y. REAL PROP. LAW § 339-e 15.
\(^{39}\) McCaughan, supra note 2, at 29.
by precluding the construction of a condominium on property held under a long-term lease. In fact, it automatically avoids one problem that may tend to tie up land in the case of a fee simple absolute. Generally, unless provided otherwise in the conveyance, the unit owner receives an absolute fee in the air space his apartment occupies if the condominium is created on a fee simple absolute. Upon total destruction and a decision not to rebuild, the fee in the cube of air space may be construed as remaining in the individual unit owner. While the problems created by destruction will be discussed subsequently, it should be observed that unless the conveyance or the condominium statute divests the unit owner of his fee, the marketability of the property after the destruction will depend upon obtaining unanimous consent of all the unit owners. This raises the specter of a recalcitrant unit owner refusing to convey unless he receives an exhorbitant price for his fee interest. This problem cannot arise in the case of a leasehold.

The use of a leasehold, however, creates a unique problem of its own. One of the principal advantages of the condominium is the independence of the condominium unit owner from the financial obligations of the other unit owners. This is contrasted with the cooperative which is burdened by a single blanket mortgage and a single tax assessment, the effect of which is to create a financial interdependence among the cooperative shareholders to collectively meet the mortgage and tax payments in order to prevent a lien on the overall project. The individual condominium unit is treated as a separate entity for both mortgage and taxation purposes with the unit owner liable exclusively for mortgage charges and tax assessments on his individual unit.

A lease on a condominium runs to the whole project and can create a problem in the event one owner does not pay his share, since it may be necessary for the other owners to meet this obligation in order that their interest will not be encumbered. This result can be avoided by proper planning, as it may be possible to divide the lease into separate leases with one covering each unit. An alternative would be a non-disturbance agreement obtained from the fee owner whereby he agrees not to disturb possession of any unit owner who

43. McCaughan, supra note 2, takes a contrary view. However, his objection is based on the fact that the lease would destroy the condominium owner's freedom from liability incurred by the other owners. As will be noted subsequently, by proper planning a condominium owner can retain financial independence from the other owners, even when the condominium is created on a leasehold.
44. 4 POWELL § 633.12(3).
46. Ibid.
47. Kerr, supra note 1, at 24.
pays his proportionate part of the rent. As the problems inherent in a leasehold can be negated by adequate planning, there appears little reason to restrict the condominium to a fee simple absolute.

V. COMMERCIAL USE

While the condominium has generally been thought of in terms of residential units, there is no reason why the concept should not be applied to commercial units, or a combination of commercial and residential units where zoning permits. In fact, the condominium concept is already being employed in some areas of the United States for office buildings, mobile home parks, and small boat harbors. Some persons believe that the greatest potential of the condominium lies in the commercial rather than the residential field.

State permissive legislation, such as the Massachusetts statute, authorizing the construction and sale of condominiums “designed primarily for dwelling purposes,” appears unduly restrictive. While a combination of residential and commercial units seems permissible as long as it is “primarily for dwelling purposes,” it would preclude an entirely commercial condominium. The better view is demonstrated by the Arkansas statute where apartment is defined as occupying “all or part of a floor in a building of one (1) or more floors or stories regardless of whether it be designed for residence,

48. Ibid.
49. The FHA Regulations regarding the eligibility of an individual condominium unit for mortgage insurance impliedly recognize that a unit may be rented, while at the same time limiting the number that can be rented by the individual insured. "(e) Mortgagor Limitations. The family unit to be covered by an insured mortgage shall be for the use and occupancy of the mortgagor or the mortgagor shall be the owner of another family unit covered by an insured mortgage for such use and occupancy. The mortgagor may not own more than four family units covered by insured mortgages, one of which shall be for his own use and occupancy." 24 C.F.R. § 234.26(e) (1962). The character of the rental use is also limited. "No family unit in a multifamily structure which has been committed to a plan of apartment ownership shall be rented or offered for rent for transient or hotel purposes as defined in § 234.15 so long as such family unit in such structure is subject to an FHA insured mortgage." 24 C.F.R. § 234.67 (1962). Section 234.15 defines hotel purposes as follows: "For the purpose of this subchapter rental for transient or hotel purposes shall mean (a) rental for any period less than 30 days; or (b) any rental if the occupants of the unit are provided customary hotel services such as room service for food and beverages, maid service, furnishing and laundering of linen, and bellboy service." 24 C.F.R. § 234.15 (1962).
50. See Beresford, supra note 2.
51. Wenig & Schulz, Government Regulation of Condominium in California, 14 Hastings L.J. 225 (1963). “The concept of fee conveyance of cubes of water space for boat storage together with tenancy in common ownership of the pilings, ramps, walkways, service area, clubhouse, parking area is referred to as the ‘wet condominium.’” Id. at 233 n.6.
52. See 4 POWELL ¶ 632 n.4 and the authorities cited therein.
for office, for the operation of an industry or business, or for any other type of independent use." 54

VI. Partition

Once the condominium is established, attention must be turned to the preservation of the regime. By definition, the individual unit owners of the condominium hold the common elements in co-tenancy. 55 One of the characteristics of a co-tenancy is the right of partition 56 and, in the absence of a provision to restrain the exercise of this right, the condominium regime may be dissolved by a single disgruntled unit owner. Such partition could result in a physical division of the property with the individual unit owners receiving a several interest corresponding to his share of the individual interest or a sale and division of the proceeds. 57

The possibility of a single unit owner disappointing the expectations of the legal integrity of the regime would practically preclude condominium activity. To meet this threat, most of the statutes expressly provide that no action for partition may be maintained. For example, the Model Act provides:

The common areas and facilities shall remain undivided and no apartment owner or any other person shall bring any action for partition or division of any part thereof. . . . Any covenant to the contrary shall be null and void. 58

The Model Act recognizes the right of all of the unit owners to remove the property from the provisions of the condominium statute 59 and that in the event of destruction with a decision not to rebuild, a partition suit may be maintained. 60

Not all of the statutes 61 expressly bar a partition action, and in such cases it would seem necessary to provide against this contingency in the declaration. The danger in these states is that a covenant not to

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56. 4 POFFEL. ¶ 611.
59. Model Act § 16; Fla. Stat. Ann. § 711.16 (Supp. 1964); New York provides for the withdrawal and partition if "authorized by at least eighty per cent in number or in common interest, or in both number and common interest, as may be specified in the by-laws." N.Y. Real Prop. Law § 339-l.
60. Model Act § 26; N.Y. Real Prop. Law § 339-cc.
partition may be construed as an indirect restraint on alienation. However, a covenant not to partition for a reasonable length of time, will generally be upheld if for a reasonable purpose. The restraint on partition seems manifestly reasonable in this instance, since the possibility that a single unit owner may bring a partition action is likely to have a greater restraining effect on the alienability of property than any bar to partition. A reasonable length of time for such restriction has been suggested as either the duration of the condominium regime or the life of the building, whichever is shorter.

Although, in the absence of a statutory provision barring partition a covenant can be drafted that will be upheld against the contention that it is invalid as a restraint against alienation, an express bar in the condominium statute seems preferable. Such a provision would tend to eliminate any litigation on this sensitive prerequisite to the vitality of a condominium, for it would also clearly manifest the legislature's intention to exclude the condominium from the effects of the rule against restraints on alienation.

The integrity of the condominium is further maintained by statutory provisions that "the common interest shall not be separated from the unit to which it appertains." Such a provision disposes of any question of whether the common elements are conveyed, even though they are not expressly mentioned in the conveying instrument.

VII. Separate Assessment

The financial independence of the individual unit owner depends partly upon a separate assessment and liability for property taxes. But in the absence of a statutory mandate, separate assessment is not assured. The assessor in such a case is confronted with three alternate methods of assessing the condominium: (1) a blanket assessment of the total regime; (2) assessment of the actual unit individually with a blanket assessment of the common elements; and (3) an individual assessment of each unit, including the proportionate interest in the common elements. By the weight of authority, the method selected is within the discretion of the assessor. When the assessor exercises

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63. 4 POWELL ¶ 633.11[2].
65. 4 POWELL ¶ 633.11[2].
66. FLA. STAT. ANN. 711.05 (1)(2) (Supp. 1964); N.Y. REAL PROP. LAW § 339-12.
68. See Note, supra note 62, for a discussion of the problems inherent in a right of first refusal.
this discretion, he will probably select the blanket assessment, for separate assessment necessarily increases the assessor's administrative burden by creating additional as well as difficult tax billing and valuation problems.\textsuperscript{70} 

In the absence of a specific statutory provision requiring separate assessment, the owners of the condominium might enter into an agreement with the assessor to tax the condominium units severally; however, this will not meet the FHA requirements for mortgage insurance. The FHA requires the mortgagee of a section 234 mortgage to certify that "property taxes in the jurisdiction where the family units are located are assessed and levied against each family unit as a taxable entity and not assessed and levied against the multifamily structure."\textsuperscript{71} This condition precedent to the issuance of mortgage insurance clearly is not met when the assessment is on a building rather than on a unit basis,\textsuperscript{72} nor is it satisfied if the assessor merely agrees to assess on an individual basis.\textsuperscript{73} The enabling act must require assessment against the individual unit and its proportionate share of the common elements.

To maintain the legal separateness implicit in the condominium and to attempt to meet the FHA regulations for mortgage insurance,\textsuperscript{74} the condominium acts generally provide expressly for separate assessment. Since the acts are not uniform in their approach, the purpose of this section is to examine the statutory provisions and attempt to ascertain the preferable statutory view.

The FHA Model Act provides:

Each apartment and its percentage of undivided interest in the common areas and facilities shall be deemed to be a parcel and shall be subject to separate assessment and taxation by each assessing unit and special district for all types of taxes authorized by law including but not limited to special ad valorem levies and special assessments. Neither the building, the property nor any of the common areas and facilities shall be deemed to be a parcel.\textsuperscript{75}

It should be noted that the Model Act provides that the assessment is made as to the unit and its proportionate share of the common elements. This would certainly seem necessary to meet the FHA mortgage insurance requirements.

The Arkansas statute differs by directing the separate assessment to the unit only:

\textsuperscript{70} 50 Calif. L. Rev. 299, 326 (1962).
\textsuperscript{71} 24 C.F.R. § 234.26(d)(3) (1962).
\textsuperscript{72} See 14 Hastings L.J. 289 (1963).
\textsuperscript{73} Wenig & Schulz, \textit{supra} note 51, at 234.
\textsuperscript{74} 24 C.F.R. § 234.26 (1962).
\textsuperscript{75} Model Act § 22; N.Y. Real Prop. Law § 339y.
Taxes, assessments and other charges of this State, or of any political sub-
division . . . shall be assessed against and collected on each individual
apartment, each of which shall be carried on the tax books as a separate
and distinct entity for that purpose, and not on the building or property as
a whole.\textsuperscript{76}

Presumably, the assessor could make a separate assessment of the
individual units and a blanket assessment of the common elements.
This would partially destroy the financial independence of the unit
owners, for if one owner failed to contribute his share toward the
blanket assessment of the common elements, the other owners must
meet this obligation or have the common elements encumbered with
a tax lien.

In practice, even under an Arkansas-type provision, the assessor
will probably choose to include the individual unit's proportionate
share of the common elements in a single assessment. Assessing the
common elements on a blanket basis would not seem particularly
advantageous to the assessor for he would still have as many separate
assessments on his rolls as if he had included the proportionate share
of the common elements in the individual assessments.\textsuperscript{77} In fact, the
valuation is simplified if the common elements are included in the
individual units. To compute the proper assessment, the assessor
could merely determine the value of the building and allocate to the
individual share its proportionate part according to that unit's interest
in the common elements. If the common facilities are assessed as a
whole, the assessor would be required to value each individual unit
separately and then subtract the sum of these assessments from the
total value of the building. Regardless of whether in practice the
assessor may include the common elements in the individual unit
assessments, leaving this discretion in the assessor's hands precludes
FHA mortgage insurance. Since much of the present condominium
interest was generated by section 234 of the National Housing Act,
it would seem that the statutes should strive to conform to its pro-
visions. Therefore, it would appear preferable for the condominium
acts to have a provision requiring the separate assessment to include
that unit's proportionate interest in the common elements.

Statutory authority for separate assessment may be particularly

\textsuperscript{76} ARK. STAT. ANN. \textsection 50-1023 (Supp. 1963). Apartment is defined in a manner
not inclusive of the common elements. "'Apartment' means an enclosed space consist-
ing of one \textsection{1} or more rooms occupying all or part of a floor in a building of one \textsection{1} or more floors or stories regardless of whether it be designed for residence,
for office, for the operation of any industry or business, or for any other type of
independent use, provided it has a direct exit to a thoroughfare or to a given
common space leading to a thoroughfare." \textsection{77} ARK. STAT. ANN. \textsection 50-1002(a) (Supp.
1963).

\textsuperscript{77} Wenig & Schulz, supra note 51.
important to those jurisdictions permitting a condominium regime on a leasehold. The lessor continues to hold the legal title and, ordinarily, the primary duty of meeting the tax obligation devolves upon the title holder. If the taxes are assessed to the lessor and if he fails to meet them, a lien encumbers the entire regime. Of course, the declaration could contain an agreement that the condominium association was responsible for these taxes; however, this might merely result in a blanket assessment. In addition, tax assessors may be reluctant to assess for property tax purposes anything less than a fee simple interest. It would seem advantageous, therefore, to provide specific statutory authority for separate assessment of less than a fee simple interest. While this is no doubt implied in jurisdictions such as Virginia where the condominium statute expressly provides for separate assessment and the act permits a condominium on a leasehold, an express provision on this point would negate any doubt.

VIII. Destruction

So far the discussion has centered on problems arising in the creation and continuation of the condominium. This section deals with destruction of the condominium. Three basic statutory approaches are taken to this matter, the first of which is demonstrated by the Arkansas statute which provides:

Reconstruction shall not be compulsory where it comprises the whole or more than two-thirds (%) of the building. In such case, and unless otherwise unanimously agreed upon by the co-owners, the indemnity shall be delivered pro rata to the co-owners entitled to it in accordance with provision made in the by-laws or in accordance with a decision of three-fourths (%) of the co-owners if there is no by-law provision.

Under this approach, where more than two-thirds of the building is destroyed, unless there is unanimous agreement to the contrary, the funds received from the insurance and the sale of lands are distributed to the owners. Upon such a contingency, the joint interest in the common elements is converted into a several interest.

The Model Act provides that if within a specified number of days from the date of destruction, the owners have not decided to reconstruct, the remaining property is deemed to be owned in common by the unit owners.

78. An agreement can be made whereby the lessee agrees to pay the taxes. See 2 Powell, § 241, at 283. But note subsequent text.
79. Wenig & Schulz, supra note 51, at 294.
If, within [___] days of the date of the damage or destruction to all or part of the property, it is not determined by the Association of Apartment Owners to repair, reconstruct or rebuild, then and in that event:
(a) The property shall be deemed to be owned in common by the apartment owners;
(b) The undivided interest in the property owned in common which shall appertain to each apartment owner shall be the percentage of undivided interest previously owned by such owner in the common areas and facilities;
(c) Any liens affecting any of the apartments shall be deemed to be transferred in accordance with the existing priorities to the percentage of the undivided interest of the apartment owner in the property as provided herein; and
(d) The property shall be subject to an action for partition at the suit of any apartment owner, in which event the net proceeds of sale, together with the net proceeds of the insurance on the property, if any, shall be considered as one fund and shall be divided among all the apartment owners in a percentage equal to the percentage of undivided interest owned by each owner in the property, after first paying out of the respective shares of the apartment owners, to the extent sufficient for the purpose, all liens on the undivided interest in the property owned by each apartment owner.83

The third approach is to leave the provisions governing the disposition of property after destruction or damage to be determined by the declaration. The Florida statute provides the declaration shall contain: “Such other provisions not inconsistent with the law as may be desired, including but not limited to those relating to . . . reconstruction or repair after casualty and votes required in connection therewith.”84

If a fee simple absolute in the air space is conveyed to the owner of the apartment, then even if the building is destroyed, the owner’s fee interest in this air space remains.85 Whenever a statute or declaration provides that the fee interests of the owners divest and then vest as tenants in common upon the happening of certain contingencies, an executory interest arises. The form of the Arkansas and Model Condominium statutes creates an executory interest which becomes possessory upon the destruction of the buildings and a decision not to reconstruct.86 Since these contingencies have no relation to lives in being plus twenty-one years, the executory interest would seem void under the rule against perpetuities.87

This application of the rule against perpetuities can be specifically negated in the condominium act. The Missouri statute provides: “It

85. Berger, supra note 64, at 1013.
86. 4 POWELL ¶ 633.12[3].
87. Ibid.
is expressly provided that the rule of property known as the rule against perpetuities and the rule of property known as the rule restricting unreasonable restraints on alienation shall not be applied to defeat any of the provisions of this chapter. A number of statutes, however, do not have such a provision. If the vesting of a tenancy in common was provided for in the declaration, such as in a Florida-type statute, the rule against perpetuities would clearly be violated. However, if the tenancy in common is created by the condominium act itself, such as in the Arkansas and Model Act, it would seem that the intention of the legislature was to create an exception to the rule against perpetuities, for otherwise the terms of the act would be defeated. To eliminate any doubt on this point, it seems preferable to provide an express statutory provision stating the rule against perpetuities has no application to any part of the condominium act.

In the absence of a statutory provision negating the rule against perpetuities, it has been suggested that the best method of avoiding the problem is to convey to the unit owner a tenancy in common to the air space occupied by his apartment, rather than a fee simple absolute, along with the common elements. Thus, at the inception of the regime, the apartment owner would receive a fee simple absolute in the walls, floors and ceiling of his apartment, along with an easement to the air space encompassed by them. Upon destruction of the building and failure to rebuild, the easement in the air space terminates and the owner holds the common elements, including the air space, as a tenant in common with the rest of the owners. Since the interest in the air space has been continually vested in all the owners of the condominium, the rule against perpetuities is not violated. This is a particularly good solution under a Florida-type statute.

IX. THE CONDOMINIUM DEVELOPER

Since the principal characteristics of condominium legislation have been examined, attention will now be turned to some of the problems inherent in developing a condominium under these statutes. Generally, it is the developer who initiates the construction and development of a condominium; and, from his standpoint, it closely resembles
a subdivision. Instead of a horizontal subdivision with single units built upon separate lots, the condominium may be characterized as a three dimensional subdivision of vertical fee simple units with an undivided interest in the land and other common elements. From this analysis of the condominium, it is apparent that, while it creates many unique problems, many of the problems confronted by the horizontal developer will likewise confront the condominium developer in only a slightly different context.

Perhaps in most instances the developer will desire to construct a condominium devoted entirely to residential units, to sell all of the units as rapidly as possible and then to completely withdraw from any further activity in regard to the particular condominium. But the economic realities may be such that it is desirable to include commercial units or hold some of the residential units for rental purposes. For example, projected sales demand schedules may indicate that the demand for the purchase of individual apartment units falls short of that required to make the condominium venture successful. There are certain fixed costs in the construction of any type of structure and the greater the number of units these fixed costs are divided by, the lower will be the cost per unit. Since it is anticipated that a substantial number of condominiums will be constructed close to business districts in metropolitan areas, an area of high land cost, the land itself will constitute a major fixed cost. High land cost may make the condominium venture profitable only if a high rise structure, having a large number of rental units in relation to ground space, is constructed. By renting some of the units, the developer may find that not only is he able to build the optimum sized building, but that he has created an attractive investment in the units retained for rental. Of course, the developer might have built a building devoted entirely to rental. However, the sale of some of the units permits him to recoup a portion of his investment in the initial stages and to diversify his investments if he decides to retain the rental units himself.

If the condominium is constructed in or near the business district, the land is likely to be so expensive as to preclude its use solely for residential purposes. Therefore, to make the optimum use of the location, it may be desirable and necessary to use the ground floor for retail stores or other commercial purposes. Persons purchasing individual units may find the construction of commercial rental units equally advantageous, since permitting the developer to build to optimum size permits him to sell all units at a lower cost. In addition,

94. Of course, a multiunit single story condominium may be created. However, this note shall concern itself principally with the problems inherent in the high rise type condominium.
if the developer must sell all the units rather than rent some, and finds that after an intensive sales effort he has certain units unsold, he may be tempted to sell these at a reduced price. This is likely to have a depressing effect upon the value of the individual units previously purchased. Including retail stores in the condominium may also make it a more convenient place to live.

The above discussion of the practical reasons why a developer might include commercial units and rental apartments in a proposed building has been premised on the assumption that the developer will choose to build a condominium. However, the cooperative also provides a vehicle to accomplish the same goals. The discussion to follow will compare the tax implications of the cooperative and the condominium with regard to the retention of commercial and rental apartments, seeking to find the superior form of ownership to accomplish the developer's objectives of providing low cost housing with a reasonable rate of investment return to him.

X. COMPARISON OF CONDOMINIUM WITH COOPERATIVE

The condominium appears distinctly superior to the cooperative in regard to the retention of commercial units or apartments for rental investment. The Internal Revenue Code permits the cooperator to deduct his pro rata share of the mortgage interest and property taxes. However, there is a restrictive definition of "Cooperative Housing Corporation" which must be satisfied in order to get the deduction. The Code defines it as a corporation:

1. COOPERATIVE HOUSING CORPORATION—
   (A) having one and only one class of stock outstanding,
   (B) each of the stockholders of which is entitled, solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation.
   (D) 80 per cent or more of the gross income of which for the taxable year in which the taxes and interest described in subsection (a) are paid or incurred is derived from tenant-stockholders.

2. TENANT-STOCKHOLDER—The term 'tenant-stockholder' means an individual who is a stockholder in a cooperative housing corporation, and whose stock is fully paid up in an amount not less than an amount shown to the satisfaction of the Secretary or his delegate as bearing a

95. The cooperator pays a periodic assessment rather than rent. He is permitted to deduct that proportion of the assessment which constitutes mortgage interest and property taxes.
96. INT. REV. CODE OF 1954, § 216(a)(1).
97. Ibid.
98. INT. REV. CODE OF 1954, § 216(b)(1).
reasonable relationship to the portion of the value of the corporation's equity in the houses or apartment building and the land on which it is situated which is attributable to the house or apartment which such individual is entitled to occupy.99

This definition does not preclude the cooperative from renting altogether. Ownership of stock by a corporate stockholder will not prevent the cooperative from qualifying as a "cooperative housing corporation," providing eighty per cent of its gross income is derived from individual tenant-stockholders.100 Nor would it appear that the deduction would be disallowed where the cooperative itself rents units, if no more than twenty per cent of its gross income is composed of such rentals.101 However, it does restrict the cooperative's renting potential and may place it in a perilous position in some instances. For example, if it was necessary for the cooperative corporation to take over any of the apartments by virtue of a default or a first refusal provision, and the rental income was then close to twenty per cent of the gross income, the cooperative might be placed in a position of either allowing an apartment to remain vacant or losing its deduction by renting and thereby exceeding the twenty per cent limitation. This twenty per cent restriction can be circumvented to an extent. The individual tenant-stockholder is not required actually to occupy the apartment; it is sufficient if he has the right to occupy it.102 Therefore, an individual who has the right to occupy the apartment may sublease it to a third party and still have the amount of his assessment classified in the eighty per cent of the gross income derived from tenant-stockholders.103

The condominium's advantage lies in the fact that there is no limit upon the amount of gross income derived from sources other than the individual apartment owners. The deduction for mortgage interest and property tax104 may be taken by the individual unit owner regardless of the proportion of gross income derived from rentals.105 This result flows from the fact that each unit is treated separately for


101. "The sale of floor space in a cooperative apartment building, which has been incorporated as a cooperative apartment corporation, to a banking corporation, or real estate partnership, to be used for commercial purposes will not prevent the cooperative apartment corporation from being classified as a 'cooperative housing corporation' within the meaning of section 216(b)(1)(B) of the Internal Revenue Code of 1954, provided that 80 per cent of its gross income is derived from tenant-stockholders who are individuals." Rev. Rul. 421, 1958-2 COM. BULL. 112.


103. See note 70 supra.

104. See note 1 supra, for the deductions allowed a condominium-homeowner.

property taxes and mortgage purposes. Therefore, the problems inherent in the blanket assessment and mortgage interest of the cooperative are not present.

Both the owner of a condominium unit\textsuperscript{106} and the tenant-stockholder in a cooperative housing corporation\textsuperscript{107} may now take an allowance for depreciation if the unit is used in business or held for rental. Previously, the deduction had been denied the tenant-stockholder in the stock cooperative because his investment represented an investment in such stock only, and no part of it could be allocated to the lease rights acquired with such stock\textsuperscript{108}. However, the Code was amended and the tenant-stockholder may now deduct depreciation "to the extent such proprietary lease or right of tenancy is used by such tenant-stockholder in a trade or business for the production of income."\textsuperscript{109} Therefore, the condominium offers no advantage over the cooperative in this respect.

On the whole, the condominium is superior to the cooperative in regard to the tax treatment accorded it when commercial or residential units are held for rental purposes since the condominium is not limited in the proportion of income derived from non-residential apartment owners. Prospective developers are certain to prefer it to the cooperative.

Assuming a developer finds practical justification to include within the condominium plans commercial or residential rental units, he will be confronted with several alternatives. First, he can include these units in the common elements of the individual residential units; second, he can sell them to an investor; or finally, he can retain the units for his own investment. The subsequent analysis will seek to determine which of these alternatives should be chosen and what tax and functional consequences will flow from the choice.

XI. TAX TREATMENT OF THE CONDOMINIUM ASSOCIATION

The analysis will begin with the consequences of the inclusion of the commercial units in the common elements of the individual owners. The immediate result is that each individual apartment owner takes an undivided interest in the commercial units. This has the effect of requiring the apartment owner not only to purchase a fee simple interest in a place of residence, but also to make an investment. Necessarily, the cost of the apartment unit would be increased to the extent of the proportionate value of the undivided interest in

\textsuperscript{106} Int. Rev. Code of 1954, § 167(a).
\textsuperscript{107} Int. Rev. Code of 1954, § 216(c).
\textsuperscript{109} Int. Rev. Code of 1954, § 216(c).
the commercial units. While this may prove attractive to some potential owners, others may not wish to have their investment choice made for them. Assuming that the forced investment choice is not undesirable in itself, the question arises as to the tax treatment accorded the rental income. Specifically, can the condominium be established in a manner to avoid double taxation? The answer lies in the nature of the association established to conduct the business of the condominium.

The condominium needs some form of management, for the by-laws are not self-executing. If the condominium is composed of more than a few individual owners, it would seem to preclude their active participation in the day-to-day operations of the condominium. Therefore, a management association must be established. Such management can be achieved by an incorporated or incorporated association, the choice of which will be governed by both tax and private law considerations.

If the corporate form is selected, the apartment owners may be able to achieve limited liability not generally attainable in the unincorporated association. However, this limited liability is not without cost. If the incorporated association handles the renting of the commercial units and the individual apartments retained for rental, it will be taxed on the receipt of the rental income. If this rental income is subsequently distributed to the apartment owners proportionately, they will receive dividend income. While this double taxation may not be undesirable to some owners, others are certain to prefer to make an investment which is directly taxed to them.

It is questionable whether this double taxation can be avoided if the apartment owners establish an unincorporated association. If it has the characteristics of an association, as defined by the regulations, then it will be classified for tax purposes as a corporation. The regulations provide that the presence of the following characteristics will cause an organization to be classified as an association:

(i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property and (vi) free transferability of interests. Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of each of these corporate characteristics. . . .

110. See Berger, supra note 64.
111. It should be recognized that the managing corporation might under certain circumstances be treated as simply the agent for the owners. Or the doctrine of “piercing the corporate veil” might be invoked if the association carries on its business in a fashion incompatible with the corporate form. See id. at 1007-08.
112. INT. REV. CODE OF 1954, § 61(a)(5).
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.\textsuperscript{114}

Analysis indicates that the condominium management association closely resembles the regulation's definition of an "Association."

An objective to carry on business for profit and associates are essential characteristics of all organizations engaged in business for profit.\textsuperscript{115} The absence of either will cause the arrangement among co-owners not to be classified as an association.\textsuperscript{116} Certainly, the owners of the individual units would be considered associates. Whether the condominium association is engaged in a business for profit when it rents commercial or apartment units is a closer question. In the case of an investment trust, the mere holding of the property under a trust indenture, which contains no powers beyond those necessary for the preservation of the trust property and the collection of income therefrom, did not constitute more than a strict trust, and not an association taxable as a corporation.\textsuperscript{117} The regulations provide: "Mere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership."\textsuperscript{118} However, a recent case held that trusts which had as their principal assets apartment buildings were conducting a business for the purposes of sharing gains therefrom where the trust saw to the physical maintenance of the buildings, the rental of the apartment units, the hiring of the janitor, contracting for repairs, and collection of rents.\textsuperscript{119} It seems that these activities would be necessary in the operation of the commercial units by the condominium association. Therefore, associates and an objective to carry on business appear implicit in the condominium context.

Once these two characteristics are found, it is necessary to look to the other characteristics to determine if the owners of the individual units will be taxed as a partnership or a corporation. "An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than non-corporate characteristics."\textsuperscript{120} Continuity of life is implicit in the condominium.\textsuperscript{121}

The condominium is designed to last for the life of the building or

\textsuperscript{114} Treas. Reg. § 301.7701-2 (1960).
\textsuperscript{115} Treas. Reg. § 301.7701-3(a)(2) (1960).
\textsuperscript{116} Ibid.
\textsuperscript{118} Treas. Reg. § 301.7701-3(a) (1963).
\textsuperscript{119} Mid-Ridge Inv. Co. v. United States, 214 F. Supp. 8 (E.D. Wis. 1962).
\textsuperscript{120} Treas. Reg. § 301.7701-2(b)(1) (1960).
\textsuperscript{121} "An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization." Treas. Reg. § 301.7701-2(b)(1) (1960).
until a majority of the unit owners vote for dissolution.\textsuperscript{122} The death or withdrawal of an individual owner will not cause its dissolution.

Since each owner is free to sell his interest, it is clear that the condominium property is freely transferable.\textsuperscript{123} The fact that the condominium has a right to a first offer may result in this characteristic being given less weight, but it does not negate it. The regulations provide:

If each member of an organization can transfer his interest to a person who is not a member of the organization only after having offered such interest to the other members at its fair market value, it will be recognized that a modified form of transferability of interest exists. In determining the classification of an organization, the presence of this modified corporate characteristic will be accorded less significance than if such characteristic were present in an unmodified format.\textsuperscript{124}

Therefore, free transferability, at least as far as planning is concerned, must be considered present.

Perhaps the most difficult characteristic to determine within the condominium context is that of centralization of management. In a condominium of any size, it is obvious that all of the owners of the individual units cannot sign each contract entered into by the condominium. Necessarily, these functions must be delegated to a managing association. The regulations provide:

Centralized management means a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization. Thus, there is not centralized management when the centralized authority is merely to perform ministerial acts as an agent at the discretion of a principal.\textsuperscript{125}

It would appear, therefore, that if the management organization has ultimate authority to make decisions binding upon the individual unit owner, there is centralized management. The more individual members the condominium has, the more likely there is to be centralization of management.\textsuperscript{126} These are rough guidelines and leave uncertain the intermediate situations. For example, it has been said that in the typical condominium the association has considerable authority, but

\textsuperscript{122} See 14 Hastings L.J. 270 (1963).
\textsuperscript{123} Treas. Reg. § 301.7701-2(e)(1) (1960).
\textsuperscript{124} Treas. Reg. § 301.7701-2(e)(2) (1960).
\textsuperscript{125} Treas. Reg. § 301.7701-2(c)(3) (1960).
\textsuperscript{126} "The effective operation of a business organization comprised of many members generally depends upon the centralization in the hands of a few of exclusive authority to make management decisions for the organization, and therefore, centralized management is more likely to be found in such an organization than in a smaller organization." Treas. Reg. § 301.7701-2(c)(2) (1960).
must often seek approval of the unit owners before major expenditures are undertaken.\textsuperscript{127} Thus, proper planning might eliminate the centralized management. However, in the larger condominium, practicalities would seem to preclude anything but a centralized form of management.

The one association characteristic missing from the condominium is limited liability. Limited liability is not generally enjoyed by the unit owners of an unincorporated management association.\textsuperscript{128}

It would appear that four of the six characteristics of the regulations' definition of association are generally found in the condominium: associates, objective to carry on business and divide the gains therefrom, continuity of life, and free transferability of interests. The fifth characteristic, centralization of management, may also be found. Therefore, there is a strong likelihood that the condominium will be taxed as a corporation even absent limited liability. While the double taxation resulting therefrom may not in itself be sufficient to prevent the inclusion of the commercial units in the common elements, it is a factor to be considered when selecting among the alternatives suggested above.

Even if the condominium association is taxed as a corporation, consideration might be given to eliminating the double taxation aspect by using the income from the rental units to offset the operating expenses of the condominium. This would be reflected in reduced assessments to the individual unit owner. There appears to be a split of authority on the effectiveness of this scheme. In Anaheim Union Water Co. v. Commissioner,\textsuperscript{129} the Tax Court was confronted with a case in which a non-profit, but not tax exempt, water irrigation corporation sold water exclusively to its shareholders. The corporation also had income from other sources. The corporation fixed its water charges to its shareholders below cost so that its water and non-water income together would annually approximate its water costs and leave it without profit. The Commissioner asserted that the expenses incurred by Anaheim in delivering water to its shareholders were not deductible expenses to the extent that they exceeded the proceeds received by Anaheim from the sale of the water. The Tax Court agreed with the Commissioner and held that to the extent that the water costs were in excess of the charges to the shareholders for such water or water services, the expenses were not deductible as "ordinary and necessary" business expenses under section 23(a)(1)(A) of the 1939 Code and section 162 of the 1954 Code. The

\textsuperscript{127} Berger, Condominium: Shelter on a Statutory Foundation, 63 Colum. L. Rev. 987, 1000 (1963).

\textsuperscript{128} Id. at 1009.

\textsuperscript{129} 35 T.C. 1072 (1961), rev'd, 321 F.2d 253 (9th Cir. 1963).
Ninth Circuit Court of Appeals reversed.\textsuperscript{130} It agreed that the Commissioner's argument that expenditures made for production when it is not intended that they will be recouped out of product sales is not an ordinary expense of the business, would be

persuasive in the case of a taxpayer carrying on business for profit, and perhaps even in other cases. But Anaheim's expenditures must be determined ordinary or not on the basis of what is ordinary for business of the nature and scope of Anaheim's . . . Anaheim's articles of incorporation require that it furnish and deliver water to those of its shareholders who desire to purchase water, at net cost, that is, cost after the application of its expenses of all incidental incomes it derives in its operations. This requirement results from the provisions that all of Anaheim's income shall be used to accomplish the furnishing of water to shareholders without profit.\textsuperscript{131}

The Ninth Circuit's rationale would seem to permit the condominium association to eliminate all taxation of income derived from its rental sources as long as it adjusts its assessments to eliminate any excess of income over costs. This, of course, depends upon whether it qualifies as a non-profit organization within the meaning of that case. The services rendered to the condominium owners would seem to be as non-profit as those rendered to Anaheim's shareholders, especially in view of the present tax policy not to consider the occupancy of a home as imputed income.\textsuperscript{132} While the rental of the commercial and apartment units is a business for profit, so was the source of the non-water related income in Anaheim.

After the Tax Court's decision in Anaheim, but before the Ninth Circuit reversed, the Seventh Circuit was confronted with substantially the same issue.\textsuperscript{133} In this case the taxpayer undertook to reduce rental obligations of shareholders by the amount of nonshareholder income. In following the Tax Court's result in Anaheim, the Seventh Circuit found the "two cases cannot be legally distinguished."\textsuperscript{134} The Seventh Circuit held that to the extent that the taxpayer had credited its shareholders with nonshareholder income it could not treat its expenses in providing services and facilities to its shareholders as "ordinary and necessary" business expenses. It would appear, therefore, that the Seventh Circuit would find the condominium association taxable in the amount of the income received from its

\textsuperscript{130} 321 F.2d 253 (9th Cir. 1963).
\textsuperscript{131} Id. at 258 (Emphasis added).
\textsuperscript{132} See note 1 supra.
\textsuperscript{133} Chicago & W.I.R.R. v. Commissioner, 303 F.2d 796 (7th Cir.), reversed on rehearing, 310 F.2d 380 (1962). After the first decision, Congress enacted P.L. 87-870 adding a new Code section 281. This gives special relief to terminal railroad corporations and their shareholders from the effect of the Anaheim and Chicago & W.I.R.R. cases. However, the rationale of these cases applies to all other corporations.
\textsuperscript{134} 303 F.2d at 801.
rental units, even if the assessments of the individual owners were adjusted to off-set these profits.

If such a result follows, then the next question is whether the profits derived from the rental units are constructive dividends to the unit owners. The regulations provide:

(a) General Rule. Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.\[135\]

It would seem that if the management association used the profits of the rental units to reduce the assessments to the individual unit owners, this would constitute a crediting to the owner's account. If so, then the Tax Court's decision in *Julius C. Winkelman*\[136\] makes the last step in the constructive receipt of dividends complete. There the court held that income credited to a taxpayer to off-set charges made was constructively received; and, therefore, constituted taxable income.

The above analysis indicates that if the commercial or rental units are included in the common elements of the individual owners, there is a strong likelihood that the condominium association will be taxed as a corporation. The effectiveness of off-setting income from the commercial units against operating costs incurred by reducing the assessment of the individual owners appears to depend upon the particular circuit. The Commissioner has neither acquiesced nor refused to acquiesce in the *Anaheim* case.\[137\] It seems reasonable that the Commissioner, when confronted by an off-setting of income in the condominium, will attempt to have the income taxed to the association even in the Ninth Circuit. Otherwise, possibilities of tax avoidance schemes will permeate future mixed condominiums. Even if the association should ultimately prevail in its contention that the income can be off-set by cost of services to unit owners, there is every prospect of expensive litigation. Therefore, in view of the likely litigation and the closeness of the issue, tax planning based upon the *Anaheim* decision seems dubious.

This analysis concludes that there are few tax advantages to be gained by the individual owners retaining the commercial units in the common elements. It must be recognized that this is a forced investment, and perhaps the individual owner would prefer to make his own investment choice. Also, a potential homeowner might prefer

137. 1 CCH 1965 STAND. FED. TAX REP. ¶ 81,241.
to remain just that, and not to make additional investment in a commercial enterprise. There may be a market for condominium units with an investment element, but in the absence of a strong potential market for this type of condominium, it is suggested that the developer either retain these units or sell them to an investor.

The choice of either of these alternatives raises problems, and the subsequent sections of this note will explore some of these. While the discussion will assume that the developer has retained the units, it is obvious that the analysis is also applicable to the investor who purchases the units.

XII. RECONCILIATION OF VOTING RIGHTS

A functional problem inherent in permitting the developer to retain apartment or commercial units for rental is reconciling the voting control exercised by the owners of the condominium. Since the owners of the individual units collectively own the entire condominium, they possess the right to manage its affairs. In the cooperative, each member has one vote regardless of the value of his interest.\footnote{138. See 31 Geo. Wash. L. Rev. 1014 (1963), for a comparison of the FHA condominium with the FHA cooperative.} But in the condominium, the weighing of the votes is generally determined by the proportion which the basic value of the unit bears to the total value of all units in the condominium.\footnote{139. Ibid.}

This method is required by the FHA as a condition precedent to the issuance of mortgage insurance on the individual unit.\footnote{140. 24 C.F.R. § 234.26 (1962).} The FHA's distinction between the cooperative and the condominium is based upon a desire for adequate protection for its guarantee of the mortgages. If the FHA was required to foreclose on the cooperative, it would take over the entire unit, for the mortgage on a cooperative is a blanket mortgage on the building. However, in the condominium arrangement, each owner obtains a mortgage on his separate unit. Therefore, if the mortgagee were required to foreclose, the FHA would acquire only the individual unit. The FHA feels that it will have adequate protection only if it has a voice in the management equal to the proportional value of the unit.\footnote{141. Supra note 138, at 1024.}

A functional problem arises when the developer retains units comprising a substantial percentage of the value of the condominium. If the voting power is proportioned strictly on the value of the interest, then the developer may have a dominant voice in the management. This would certainly be true where the retained units consti-
tuted more than fifty per cent of the value. It would seem that in
many instances the interests of the developer as an investor in
rental units would conflict with those of the individual unit owners,
whose dominant interests are those of a homeowner. Of course, the
declaration could exclude the developer from any voice in the
management. This would not seem to violate the policy of the FHA
as regards individual units insured. Of course, the developer would
not qualify for FHA mortgage insurance, but since this insurance is
limited to no more than four units per owner, and the developer will
probably need conventional financing anyway. However, the de-
veloper and his conventional mortgagee will no doubt be unwilling
to have all decisions regarding the building determined by the apart-
ment owners. Therefore, a method to reconcile these interests is
necessary.

It has been suggested that to base voting power on all matters
effecting the condominium strictly in conformity with economic
interests is undesirable. When the decisions are economic in
character, then perhaps the economic test is proper. However, many
decisions are basically social in nature, and in this area the economic
test loses much of its appeal and unduly favors the owners of the
more expensive units. It was suggested that the economic interests
could be decided on the basis of the economic test, whereas the social
questions by a majority of those owners affected. Such a distinction
might be helpful in reconciling the conflicting interests of the de-
veloper and the homeowner. However, it is recognized that even with
such a distinction a potential conflict exists, for the developer's in-
terest in economic matters would seem to be to minimize expense in
order to maximize profit. This could conflict with a desire on the part
of the homeowner to make his place of abode as attractive and
liveable as possible, with economic considerations playing a secondary
role.

One method of reconciling these conflicting interests and remaining
within the criteria of the FHA would be to differentiate the common
elements. Some statutes permit the reservation of particular common
elements for the use of certain units to the exclusion of others. These limited common elements may be advantageously
used in the mixed commercial and residential condominium. For

143. See note 49 supra.
144. 37 Tul. L. Rev. 482 (1963).
145. Ibid.
146. For example, roofs, halls, lobbies, parking areas, elevators, heating equipment,
the FHA regulations concerning mortgage insurance would not seem to preclude their
use.
148. Common expenses can also be allocated according to the benefit derived. See
note 2 supra.
example, the high rise condominium could have a swimming pool and sun deck on the roof as common elements appurtenant to the individually owned apartments, but not part of the common elements of the commercial units. In fact, even the rental apartment units could be excluded from participation in certain elements with a provision that, if subsequently sold, the purchaser might pay a sum to obtain an undivided interest in these common elements. Since only those persons having the dominant economic and social interest in these areas hold title to them, the conflict between the developer-investor and the apartment owner is lessened in a particularly sensitive area.

There still will remain elements common to both the rental units and the individually owned apartments, but the interests of the investor and the apartment owners begin to coincide in regard to these facilities and there is less likelihood of a conflict of interest. However, it might be preferable to place in the condominium declaration a provision calling for arbitration in the event of a conflict over maintenance or additions or improvements to the common elements when the developer and a majority of the owners of individual units take opposing views. In some cases, such as changes in the parcels held by the condominium, unanimous approval by all of the owners, including the developer, may be required.

XIII. CONDOMINIUM DEVELOPER AS A DEALER—TAX PROBLEMS

If the condominium developer retains certain units for rental, whether individual apartments or commercial units, it is reasonable to assume that at some future date he will consider the possibility of selling these units. Upon such an occurrence, the question will arise whether any gain will be treated for tax purposes as ordinary income or capital gain. The answer must be determined under sections 1221 and 1231 of the Internal Revenue Code. Section 1221 defines capital asset, but excludes "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business." An apartment building constructed for the purpose of renting the apartments has been held to be property used in a trade or business. Therefore, rental condominium units would be excluded from 1221, but may qualify for 1231 treatment.

Section 1231 provides that real estate used in the taxpayer's trade

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149. For example, roofs, halls, lobbies, parking areas, elevators, heating equipment, and land.
150. INT. REV. CODE OF 1954, § 1221(c).
or business may produce either capital gain or ordinary loss. But here again exclusions become all important. The first is for “property of a kind which would properly be includable in the inventory of the taxpayer if on hand at the close of the taxable year.” This exclusion is relatively unimportant to the condominium developer for real estate is not generally inventoried. But the exclusion for “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business” creates the major difficulty in this area. In order for the condominium developer to obtain capital gain treatment, it is necessary for him to avoid this exclusionary proviso. Judicial shorthand has caused the inquiry into whether the property is held for sale to customers in the ordinary course of business to be a determination of whether the owner is a “dealer” with regard to the property resulting in the gain. While the language of section 1231 places the emphasis on the nature of the property itself and the manner and purpose for which it is held, the dealer concept focuses principal attention on the owner of the property and his business activities.

Although it is recognized that the owner of real property may occupy the dual role of an investor and a dealer in real estate, his lot is not as simple as that of the dealer in securities. The latter may earmark securities held for investment by so identifying the securities on his records and not thereafter holding them primarily for sale to customers in the ordinary course of his trade or business. But the real estate dealer does not have such a provision available. He must establish by evidence that he is holding the property as an investment. His problems are further complicated by the fact that the Internal Revenue Service takes the position that a dealer in real estate is presumed to hold all his real estate for sale in the ordinary course of business, although this is, of course, a rebuttable presumption.

In seeking to ascertain avenues by which a condominium developer

\begin{footnotes}
152. INT. REV. CODE OF 1954, § 1231(a).
154. Willard Pope, 28 B.T.A. 1255 (1933), rev’d on other grounds, 77 F.2d 599 (6th Cir. 1935).
159. INT. REV. CODE OF 1954, § 1236.
160. Emmanuel, supra note 157.
161. Ibid.
\end{footnotes}
may retain some of the units for a rental investment and still avoid the dealer classification in regard to these units, the examination of authorities will concentrate upon those tending to bear upon the peculiar aspects of condominium. It should be noted at the outset that because the determination of the dealer status is one dependent upon the facts of the particular case, there is no "landmark" decision in this area despite a great number of cases considering the problem. Particular emphasis will be placed upon the initial planning of the condominium so that there will be greater likelihood of the developer receiving capital gains treatment. While the cases to date have involved situations in which a developer of a horizontal subdivision has retained some of the units for rental or a dealer in the business of purchasing houses or apartments for resale has retained some for rental, the principles derived from these cases should control subsequent ones involving high rise condominiums.

The general approach to the issue of whether the owner is a dealer or investor in regard to the properties sold is epitomized by the Tax Court's statement in D. G. Bradley. The question is essentially one of fact with no single factor being decisive. The purpose for which the property was acquired; the substantiality, frequency, and continuity of sales; the activity of the taxpayer and those acting for him; and the treatment of the property in the taxpayer's records are all to some extent determinative of the purpose for which the property was held during the period in question.

Although the statement indicates the factors a court will look to, it does not purport to indicate the weight accorded to any particular factor. This weighting varies from court to court, sometimes resulting in different conclusions based upon substantially similar facts. While the uncertainty engendered by the inconsistent decisions is subject to criticism, this note will not seek to enter this thicket and will concentrate on avoiding the pitfalls, albeit inconsistent ones, encountered within the condominium context.

Even though the condominium developer constructs certain of the units for resale, where other units are constructed and held primarily as an investment for rental revenue, they will not be classified as property held "primarily for sale to customers in the ordinary course of trade or business" simply because of the resale units. If the condominium developer intends to rent or sell the

163. 26 T.C. 970 (1956).
164. Id. at 977.
165. See Pennell, supra note 162.
166. Nelson A. Farry, supra note 158.
unit, whichever proves the more profitable, then no doubt he will be held to have manifested an essential purpose to sell. As a corollary to this, if he intends to sell some of the units and retain some for rental, but fails to delineate between the two types and stands ready and willing to sell a unit whenever favorable offers are received, the developer will be declared a dealer in regard to all the units.

It is, therefore, apparent that the condominium developer must exercise sagacity in establishing by outward manifestations a clear investment intention. One method of accomplishing this is by segregating on the records of the developer the two types of units. Another method is by taking title to the rental units in a separate corporation created for this purpose. However, care must be exercised to avoid the creation of a personal holding company. Prior to 1964, if the gross amount of rents equalled fifty per cent or more of the gross income of the corporation, such rents were not considered personal holding company income. The 1964 Act has tightened the personal holding company provision with respect to rents. It requires the inclusion of the adjusted income from rents unless two requirements are met. The first is that adjusted income from rents must constitute fifty per cent or more of the adjusted ordinary income. The adjusted income from rents is determined by reducing gross rents by deductions for depreciation and amortization, property taxes, interest, and rent paid. The second requirement is that personal holding company income from sources other than rents and use of corporation property by shareholders, and including as personal holding company income copyright royalties and the adjusted income from mineral, oil, and gas royalties, be not more than ten per cent of ordinary gross income as defined in section 543(b)(1). Section 543(b)(1) defines ordinary gross income as gross income determined by excluding gains from the sale or other disposition of capital assets and all gains from the sale or other disposition of section 1231(b) property. While the 1964 Act generally necessitates a greater proportion of rents to avoid the personal holding

167. Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951).
169. Delsing v. Commissioner, 186 F.2d 59 (5th Cir. 1951); Palm Homes, Inc., 11 CCH Tax Ct. Mem. 28 (1952).
170. Levin, supra note 156.
171. INT. REV. CODE OF 1954, § 543.
company provisions, a corporation or association taxed as a corporation engaged exclusively in the business of renting would avoid its provision.

Once the condominium has been constructed, the developer should refrain from placing “for sale” signs on the investment units and carefully exclude them from any advertising of the units intended for sale. A long-term mortgage on the rental units will tend to show their investment character, especially if the mortgage application form states an intention to rent.

The adequacy of the rental income itself may indicate the character of the holding. An inadequate or nominal rental income tends to show that the holding is temporary, consistent with an intent to sell in the ordinary course of business. In other words, a court may look to see if it was a good investment in order to determine if it was an investment in fact. In C. T. Grace, the Commissioner advanced a theory that would have in effect negated the showing of substantial rental income as a positive factor indicating an investment purpose. The Commissioner argued that it is necessary for one dealing in rental property to hold the property for a period in order to have a record of income for a prospective buyer to estimate his return on the ensuing investment. The court rejected this argument, noting that it might be wise for a dealer of apartment houses to have an earnings record to show a prospective buyer or a fully rented apartment when he sells so that, in effect, he would be selling a going enterprise rather than just a bare building. But the court said it would look to the facts peculiar to each case, and the facts of Grace, especially the fact that the apartment had been rented for over four years, demonstrated an obvious investment purpose. Grace also demonstrates the importance attached to the length of time the property is held for rental purposes. However, rental during a delay caused by a failure to find customers to purchase the unit will not convert the unit from one held for sale to customers into a holding for investment.

177. Ibid.
180. As will be noted subsequently, inadequate rent may also be evidence of an intent to liquidate a rental business.
182. Supra note 178.
183. Neils Schultz, 44 B.T.A. 146 (1941); “The fact that 69 houses were rented is not inconsistent with a purpose to hold the houses primarily for sale . . . particularly where, as here, the houses were rented for varying periods of from 9 to 20 months.” Alice E. Cohn, 21 T.C. 90 (1953).
The method of renting may also be of importance. In *Louis Rubino*, the court, in ruling that the taxpayer was holding property primarily for sale to customers in the ordinary course of business, stressed the fact that the dwellings were rented on oral leases on a month-to-month basis, and indicated that this was strong evidence that he wished to keep his property readily available for sale. A functional problem may be presented where the lessees prefer a month-to-month oral lease. An option to purchase in the lease may also be considered as a manifestation of an intent to sell rather than to hold for investment.

The ultimate question in the resolution of the dealer issue is the purpose for which the property is *held at the time of sale*. Of course, this statement cannot be taken literally, for at the instant the property is sold there was necessarily an intention to sell. What the courts seem to mean is whether an investment purpose existed just prior to sale. But regardless of the terminology, the finding is particularly important where the investor seeks to liquidate his rental properties previously held for an investment purpose. It seems perfectly obvious that an investor should not be required to keep his investment in perpetuity. However, the weight accorded to the character of the holding prior to liquidation varies among the courts. Some courts hold that the fact that the property is sold for purposes of liquidation does not foreclose a determination that a trade or business is being conducted when the frequency or continuity of the transactions claimed are sufficient to show a business status. Even these courts would seem to hold that where the elements of development and sales activity are absent or insufficient to change the investment purpose, the fact of liquidation may not be disregarded. There must be shown an abandonment of the rental business and an engagement in the real estate business for the purpose of selling the rental units to its customers in the ordinary course of the new business. In addition, since the ultimate question is the purpose for which the units are held, the purpose of acquisition,

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188. *Ibid*.
189. *Pennell*, *supra* note 162.
while not determinative, will be helpful in resolving the former and the purpose for which the property was held immediately prior to sale will be particularly important.

Other courts place greater emphasis on the fact of liquidation. Judge Tuttle, in *Goldberg v. Commissioner*, stated:

> The test as to whether the capital gain provisions apply in such event is, at bottom, whether the purpose of the sales is primarily making money by carrying on a substantial part of the activities of a person engaged in the business of selling houses, or to dispose of or liquidate the rental business. If the latter is the case, the owner obtains capital gains benefits.

In reversing a Tax Court holding that because of the manner in which the sales were made they were conducted in the ordinary course of business, the court in *Curtis Co. v. Commissioner*, cited with approval the above statement of Judge Tuttle. In *Curtis* the Commissioner had conceded that if the property had been sold in one lump sum to a buyer, there would have been capital gains. To this the court replied:

> Is the taxpayer any worse off because it did the selling itself and by single parcels instead of job lots? We do not see how it can be fairly said so. With the concession that up to the very minute of decision to get out of the housing rental business the property was held for investment and with the undisputed fact that after the rental properties were sold the taxpayer turned its attention to other activities, we do not see that there is basis for saying that the regular course of its business, as to these houses, was real estate selling. We think it a case of one having an investment property on hand which he wants to turn into another form of investment. By the very nature of the case he had to sell the properties a piece at a time. Surely that does not make him a ‘dealer’ in these parcels of land any more than it would make a man a dealer if he wanted to liquidate his holdings in a corporate stock for which the market was weak so that he had to sell by small parcels instead of by one sale.

Other circuits and the Court of Claims adopt the same rationale and treat the frequency of sales as merely another factor for con-

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197. 223 F.2d 709 (5th Cir. 1955).
198. *Id.* at 712. This principle was reaffirmed by the Fifth Circuit in Alabama Mineral Land Co. v. Commissioner, 250 F.2d 870 (5th Cir. 1957).
199. 232 F.2d 167 (3d Cir. 1956).
200. *Id.* at 169-70.
201. Yunker v. Commissioner, 256 F.2d 130 (6th Cir. 1958); Chandler v. United States, 226 F.2d 403 (7th Cir. 1955).
sideration in liquidation cases rather than the governing factor. But regardless of the view of the different courts, it must be borne in mind that the single factor having the greatest impact on all the courts is the selling activity of the owner.\textsuperscript{203} It seems relatively safe to say that, if the owner sits back and lets the purchasers approach him without attempting to attract them, in most cases, he will receive capital gains treatment. However, this is hardly the prevalent method of liquidating property. The condominium developer should ascertain the attitude of those courts in which he may have to litigate the matter, and plan his liquidating activities accordingly, always seeking to minimize his sales activity.

In addition to complete liquidation, a property owner is not precluded from making frequent or infrequent sales of individual units of his investment properties in accordance with his best judgment for the disposition of such investment property,\textsuperscript{204} providing the elements of engaging in the real estate business are not present. Perhaps here inadequacy of rent of particular units might be viewed as particularly important.

The foregoing discussion demonstrates the necessity for proper planning on the part of the condominium developer in order to avoid the "dealer" label. Since the problems of proof are so great, the developer should do everything possible to establish the investment character of the rental units at the earliest possible moment and not do it as an afterthought or wait until the Commissioner questions the character of the sale.\textsuperscript{205} The developer should determine before the sales activity begins the specific units he desires to retain for rental.\textsuperscript{206} The sales information should carefully exclude these units. If residential units are retained for rental, excluding from the common elements the common recreational facilities would seem to manifest a rental-investment purpose. For example, a high rise condominium might contain commercial units on the ground floor, rental units on the next four floors, with the upper floors composed of individual units held for sale to individuals. Giving only the latter owners an interest in the common recreational facilities will preserve their interest in having only a stable, responsible group jointly use these facilities, while demonstrating the developer's intent to hold the rental units as an investment.

While the condominium provides a unique opportunity to show

\textsuperscript{203} Pennell, \textit{supra} note 162.

\textsuperscript{204} Ryman v. Tomlinson, 56-1 U.S. Tax Cas. ¶ 9519 (S.D. Fla. 1956).

\textsuperscript{205} See Pennell, \textit{supra} note 162.

\textsuperscript{206} While there is authority holding that property acquired for resale can subsequently be converted into a capital asset, Gabriel Leeb, 12 CCH Tax Ct. Mem. 256 (1953), the problems of proof are greatly increased.
the investment character of the retained units through the allocation of the common recreational facilities, it likewise provides equally unique problems which must be dealt with in a manner consistent with the interests of all concerned. In the hypothetical, the sale of an individual unit by the developer to a purchaser who desires the unit for a residence would not create, in the absence of a specific provision in the declaration, an interest in the new owner in the common recreational facilities. Therefore, perhaps the new owner should be given the right to pay an additional sum to the condominium association and receive an undivided interest in these facilities. Otherwise, the lack of these facilities would materially affect the desirability of the rental unit as a residence, resulting, no doubt, in a decrease in its value. Of course, provision should be made to see that the right to purchase an interest in the common facilities is negated where the new owner desires to retain the investment character of the unit and rent it to third persons.

A problem of some complexity arises when the developer decides to terminate his entire rental investment by liquidation. The right of first refusal may be thwarted because of the need of the owners of the individual units to purchase a large number of units to protect their interest. They may have neither the funds nor the inclination to enter the real estate business to dispose of the units to persons they deem desirable joint owners. Therefore, restraints should perhaps be placed upon the developer's right to liquidate his investment. Such restraints should not preclude the developer from liquidating, but reasonable restraints as to the time of liquidation may well serve the interests of all parties. The developer would also have the advantage of using these restraints as evidence tending to demonstrate an investment purpose in the retention of the units.

XIX. CONCLUSION

The sudden outpouring of condominium legislation has sometimes resulted in the enabling acts containing inadequately considered provisions. In their haste to get a condominium statute on the books, legislatures have often substantially copied the act of another state, thereby compounding an initial oversight. While the principles of condominium ownership are basically similar, certain provisions which would make the condominium a more viable vehicle to meet the needs of urbanization have been negated or ignored. For instance, there appears no conclusive reason why a condominium may not be created on a leasehold, or why the condominium principle should be restricted to residential uses. As more experience with condo-
minimum is gained, it is anticipated that these and other oversights will be corrected.

The condominium offers the developer more than simply an opportunity to construct the building and sell the units. It offers him the opportunity through creative planning of mixed commercial and residential condominiums to maximize the use of existing land, thereby rendering a service to society and in the process creating a more attractive investment.

Finally, the condominium is a vehicle useful in the resolution of the urban housing problem. It combines many of the advantages of home ownership with those derived from renting. Not only does it serve the community through economy in land use, but it results in a saving in the providing of necessary facilities such as roads and sewage. The condominium is not the panacea of all of the problems created by the explosive growth of our cities. However, with a proper statutory foundation and farsighted vision on the part of condominium developers, it may serve as one useful tool in the ultimate solution of our urban problems.

JAMES C. CLARK