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Condominium—Tax Aspects of Ownership

The ancient concept of condominium ownership has been revived in this country as an answer to the increasing demand for adequate urban housing. The advantages of individual home ownership have had to be subordinated by many families in favor of the convenience of apartment rental. A partial answer to this problem has been found in the creation of cooperative apartments, but this device still leaves much to be desired.¹ It was not until Puerto Rico achieved its initial success with condominiums that the advantages of this form of home ownership fully came to the attention of this country. To encourage the use of condominiums as a form of middle-income family home ownership, Congress enacted the National Housing Act of 1961.² Section 234 of the act provided authority for the Federal Housing Administration³ to insure mortgages on condominium projects in those states whose laws permit the condominium form of ownership. Accordingly, a flood of state legislation has followed in an effort to meet the requirements of section 234.⁴ In order to provide guidelines for this state legislation the FHA drafted a model statute which satisfies the requirements of section 234, and yet leaves room for modification to meet local conditions.⁵

Even with initial assistance from Congress and helpful guidance from the FHA, many legal problems are still presented by this unique form of ownership.⁶ Problems of income taxation plague every commercial venture and the condominium is no exception. Recognizing that condominium ownership's basic objective is to combine the convenience of apartment rental with the desire for home ownership, it is appropriate to inquire whether a condominium owner will be able to obtain the tax treatment accorded a conventional home owner.

I. TAXATION OF THE UNIT OWNER

A taxpayer who owns his own residence is entitled to certain tax

1. See RAMSEY, *CONDOMINIUM: THE NEW LOOK IN CO-OPS* (1961).

2. 75 Stat. 160 (1961), 12 U.S.C. § 1715y (Supp. 1964).

3. Hereinafter cited as FHA.

4. Only three states do not now have condominium property acts—Maine, New Hampshire and Vermont. Proposed acts are being considered in Maine (S.B. 194) and New Hampshire (S.B. 2). For comments on such acts, see Note 18 *VAND. L. REV.* 1773 (1965).

5. FHA Form No. 3285 (May 1962) [hereinafter cited as *FHA MODEL STATUTE*].

6. The dearth of literature in this field is now being overcome by a rapidly growing number of excellent articles written in response to these current problems. See generally Berger, *Condominium: Shelter on a Statutory Foundation*, 63 *COLUM. L. REV.* 987 (1963); Cribbet, *Condominium—Home Ownership for Megalopolis?*, 61 *MICH. L. REV.* 1207 (1963); Comment, 50 *CALIF. L. REV.* 299 (1962); 14 *HASTINGS L.J.* 189 (1963) (a series of articles devoted to condominium legislation).

benefits which are not available to a taxpayer who rents a house or an apartment as his residence. In general, these benefits are five in number: the non-recognition of gain on the sale of his principal residence; the deductions for payment of local property taxes; the deduction of interest paid on his mortgage indebtedness; the deduction of uninsured casualty losses to his property; and the deduction for depreciation if he rents or leases his property to another. Regardless of the great utility of the various physical forms and uses which condominiums provide,⁷ the individual owner must also be entitled to these tax benefits to achieve equality between condominium ownership and ownership of the more familiar individual dwellinghouse.

A. *Nonrecognition of Gain on Sale or Exchange of Residence*

The Internal Revenue Code, section 1034, provides that, within certain limitations, gain realized from the sale of a taxpayer's old residence will not be recognized if he purchases a new residence within one year.⁸ This section also provides basically the same benefit to a tenant-stockholder in a cooperative housing corporation.⁹ The Internal Revenue Service recently has declared that this treatment will be afforded a condominium owner.

[A]n individual who sells his principal residence and uses the proceeds, within one year after the sale, to purchase an apartment in a 'condominium' apartment project which he uses as his new principal residence is entitled to the relief provided for by section 1034(a) of the Internal Revenue Code of 1954.¹⁰

It should be noted that section 1034 requires the home which is sold to be the *principal residence* of the taxpayer.¹¹ This requirement may have unfavorable consequences for many condominium owners. Much of the activity in condominium development has been in

7. The concept of condominium ownership is readily adaptable to several different uses. While it is commonly used for apartment houses, it may also be used for office buildings, mobile home parks, and even marinas. The structural form used even in apartment houses may vary considerably. The most popular conception of a condominium apartment is the high rise building, but one and two story row houses have also been built. In southern California, the "cluster" condominium has also been used. Here, several multi-family units are grouped around a central common area containing recreational facilities and various service buildings. See Wenig & Schulz, *Government Regulation of Condominium in California*, 14 HASTINGS L.J. 222-24 (1963).

8. The taxpayer's gain realized from the sale of his old residence will be recognized only to the extent its adjusted sales price exceeds the cost of his new residence. Also, both the old and new property must have been used as the taxpayer's principal residence. INT. REV. CODE OF 1954, § 1034(a).

9. INT. REV. CODE OF 1954, § 1034(f).

10. Rev. Rul. 64-31, 1964-1 CUM. BULL. 300.

11. See note 8 *supra*.

southern resort areas in an effort to attract northern buyers seeking a winter home.¹² A taxpayer who purchases such a second home will probably have to recognize gain if it should ever be sold.

B. *Deduction of Property Taxes and Interest*

Section 164 of the Code permits as a deduction real property taxes paid within the taxable year. The Treasury Regulations provide that generally the taxes are deductible only by the person upon whom they are imposed.¹³ Subsection (d) of section 164 governs the apportionment of taxes between the seller and purchaser of any real property sold during the taxable year.¹⁴ Presently, a condominium owner may avail himself of the deductions provided he itemizes his deductions when filing his income tax return.¹⁵

There should be little question in most jurisdictions that the unit owner is the person upon whom the tax is imposed. This is true since most state legislation has been patterned after section 20 of the FHA Model Statute:

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.¹⁶

When each unit is separately assessed, an individual owner is liable only for his own property taxes and is thus protected if the owner of another apartment fails to pay the taxes on his unit. If the building is assessed as a whole and the taxes paid on a pro rata basis by the owners, it is possible that the failure of one owner to pay his share would make the remaining owners liable for the unpaid amount.¹⁷

The inclusion of a separate assessment clause in any condominium statute is important to avoid any doubt as to the methods used by the local assessor. While assessors may state their willingness to assess each unit separately even in the absence of a statute, the problem still remains unsolved.¹⁸ To protect the unit owner and his mortgagee fully,

12. Kenin, *Condominium: A Survey of Legal Problems and Proposed Legislation*, 17 U. MIAMI L. REV. 145, 170 (1962).

13. Treas. Reg. § 1.164-1 (1957). The person upon whom real property taxes are imposed may be determined from the tax rolls. 2 CCH 1965 STAND. FED. TAX REP. ¶ 1449.13.

14. INT. REV. CODE OF 1954, § 164(d); 2 CCH 1965 STAND. FED. TAX REP. ¶ 1460.01.

15. Rev. Rul. 64-31, 1964-1 CUM. BULL. 300.

16. FHA MODEL STATUTE § 20.

17. Kenin, *supra* note 12, at 164.

18. Berger, *supra* note 6, at 1020.

the assessor's methods must be governed by statute. Furthermore, the FHA has stated it will insure condominium mortgages in a particular jurisdiction only if "the family unit is assessed and subject to assessment for taxes pertaining only to that unit."¹⁹

Even in those instances where a condominium is not separately assessed, the unit owner should still be allowed to deduct his share of the property taxes paid. Here, the condominium owner is in a situation similar to that of a tenant-stockholder in a cooperative housing corporation who is allowed under Code section 216 to deduct his proportionate share of real estate taxes paid by the corporation.²⁰ Prior to the enactment of section 216 a tenant in a cooperative housing corporation could deduct property taxes only if he was under a contractual duty to pay them.²¹

Another problem may develop where a condominium is built upon land acquired by a long-term ground lease. Since it is the lessor who is assessed and who pays the property tax, he will be allowed the deduction even though the property tax is included in the tenant's rent. Accordingly, the tenant will be denied a deduction for the amount of property taxes which he actually pays due to higher rent unless he can deduct the amount as "additional rent" under section 162.²² However, the IRS has ruled that a tenant-stockholder in a cooperative built under a long-term ground lease may deduct his proportionate share of property taxes paid, even though legal title to the land is in the lessor.²³ One feels a condominium owner in a similar situation would receive the same treatment. In retrospect, condominium owners clearly should be allowed the property tax deduction if their unit is separately assessed, and even if it is not, they should still be allowed to deduct their proportionate share of property taxes paid by the condominium organization where the taxes are included in their assessments. Similarly, a unit owner will be

19. C.F.R. § 234.26(d) (1962), as amended, 24 C.F.R. § 234.26(d)(3) (Supp. 1964). This requirement of separate assessment will obviously require already overburdened assessors in metropolitan areas to shoulder heavier administrative loads, but with the increased use of electronic data processing equipment this should not present too great a problem. Comment, 14 *HASTINGS L.J.* 289, 293 (1963).

20. In order to take this deduction the taxpayer must qualify as a tenant-stockholder as defined by § 216(2) of the Code. Also, under § 216(b)(1) the cooperative housing corporation must have only one class of stock, all stockholders must be entitled to occupancy as a result of their stock ownership with no right to receive any distribution except on liquidation, and 80% of the gross income of the corporation must be derived from the tenant-stockholders. See generally 2 *CCH 1965 STAND. FED. TAX REP.* ¶ 2043.01.

21. *Borland v. Commissioner*, 123 F.2d 358 (7th Cir. 1941).

22. Taxes paid by a tenant to a landlord for business property are considered additional rent and are deductible by the tenant as an ordinary and necessary business expense. *Treas. Reg.* § 1.162-11 (1960).

23. *Rev. Rul.* 62-178, 1962-2 *CUM. BULL.* 91.

allowed to deduct the interest²⁴ paid on a mortgage upon the unit of which he is the legal or equitable owner.²⁵

C. Deduction for Uninsured Casualty Loss

The treatment of casualty loss in regard to a condominium may suggest a straightforward solution at first glance, but in reality the problem is a perplexing one. The Code allows an individual taxpayer to deduct uninsured casualty losses of property not connected with a trade or business in excess of 100 dollars, provided the loss arises from fire, storm, theft, or other casualties.²⁶ Of course, most losses will be reimbursed to a certain extent by insurance carried by the unit owner or the condominium management body.²⁷

Initially, a distinction should be made between damage to an individual unit²⁸ and damage to the common areas.²⁹ When damage occurs to a condominium owner's individual apartment, clearly he will be the person allowed to take the deduction. However, the question becomes who is allowed the deduction for damages to the common area?

One approach may be simply to divide the loss deduction for

24. INT. REV. CODE OF 1954, § 163.

25. Treas. Reg. § 1.163-1(b) (1962). This deduction has been expressly granted to a condominium owner. Rev. Rul. 64-31, 1964-1 CUM. BULL. 300.

26. INT. REV. CODE OF 1954, § 165(c)(3).

27. The concept of condominium ownership presents complex problems of insurance which must be solved in order to protect the condominium's continuity of life. See Ellman, *Fundamentals of Condominium and Some Insurance Problems*, 1963 INS. L.J. 733; Rohan, *Disruption of the Condominium Venture: The Problems of Casualty Loss and Insurance*, 64 COLUM. L. REV. 1045 (1964).

28. The terms "unit" and "apartment" are used by various acts to convey the same concept. FHA MODEL STATUTE § 2(a), defines "apartment" as "a part of the property intended for any type of independent use, including one or more rooms or enclosed spaces located on one or more floors (or part or parts thereof) in a building, and with a direct exit to a public street or highway or to a common area leading to such street or highway."

29. FHA MODEL STATUTE § 2(f), defines "common areas" as including "(1) The land on which the building is located; (2) The foundations, columns, girders, beams, supports, main walls, roofs, halls, corridors, lobbies, stairs, stairways, fire escapes, and entrances and exits of the building; (3) The basements, yards, gardens, parking areas and storage spaces; (4) The premises for the lodging of janitors or persons in charge of the property; (5) Installations of central services such as power, light, gas, hot and cold water, heating, refrigeration, air conditioning and incinerating; (6) The elevators, tanks, pumps, motor, fans, compressors, ducts and in general all apparatus and installations existing for common use; (7) Such community and commercial facilities as may be provided for in the Declaration; and (8) All other parts of the property necessary or convenient to its existence, maintenance and safety, or normally in common use."

A unit owner is a person owning an apartment in fee simple absolute and an undivided interest in fee simple of the common areas proportional to the value of his apartment in relation to the total value of all the apartments. FHA MODEL STATUTE § 2(b).

damage to the common area proportionately among the unit owners. This would be very unfavorable treatment from the taxpayer's point of view. Since each individual is allowed to deduct only the amount of his loss in excess of 100 dollars,³⁰ the effect in this situation would be to reduce the total deductible loss to the common area by 100 dollars multiplied by the number of unit owners. Obviously, this would present serious consequences to a condominium organization consisting of several owners. Perhaps the best solution can be reached by considering who will bear the initial financial loss due to repair of the casualty. Normally, damage to common areas will be repaired by the management body³¹ of the condominium. In the absence of complete insurance coverage, payment for the repairs will be made by the management body from the reserve funds.³² Therefore, it seems that the management body itself should be allowed a single deduction for the total amount of the uninsured casualty loss. This method will give the more favorable result of only a single 100 dollar exemption. However, if the amount of the loss is so great as to exceed the management body's reserve fund, each unit owner will have to be specially assessed in order to pay for repairs. In this event, the loss seems to fall directly on the unit owners and not the management body. There, the total deductible loss should then be divided proportionately among the unit owners. Thus, it would appear that repairs for minor damages to the common area paid out of the reserve fund may well be deductible by the management body, while the cost of repairs resulting from major damage to the common area requiring a special assessment will be divided proportionately among the unit owners.

Before considering the effects of casualty loss resulting from major damage to the apartment building, it will be necessary to examine the manner in which the allowable loss is deducted. In the leading case of *Mauer v. United States*,³³ the Court of Appeals for the Tenth

30. INT. REV. CODE OF 1954, § 165(c)(3).

31. The function of the management body is to operate and maintain the building and common areas. In a small condominium organization it may consist of all the unit owners. In a larger condominium the management body may be a committee elected by the owners, or it may be a group of employees hired by the owners and subject to their control. The type of management body that is used will be established by legislation and the various covenants of the condominium organization. See FHA MODEL STATUTE §§ 2(d), 19.

32. To qualify for FHA mortgage insurance, a regulatory agreement may be executed between the FHA and the condominium organization in which certain conditions and provisions will be imposed to protect the consumer and public interest. 24 C.F.R. § 234.26(f) (1962). The FHA has required the condominium organization to establish reserve funds for capital replacements and operating expenses. Regulatory Agreement, FHA Form No. 3278.

33. 284 F.2d 122 (10th Cir. 1960).

Circuit held that an uninsured loss sustained by the taxpayer resulting from damage to residential property was deductible from ordinary income under section 165. The government contended that a loss of residential property held for more than six months was an involuntary conversion and should be offset against capital gains as required by section 1231. The court reasoned that while a compensated loss is similar to an involuntary sale or exchange, an uncompensated loss is entirely different and presents "no rational basis for capital loss treatment."³⁴ In the similar case of *Morrison v. United States*,³⁵ a federal district court adopted the above reasoning, adding that section 1231 should not be considered in isolation from other sections of the Code. The court said only "a rather involved process of rationalization and a series of inferences"³⁶ could defeat the taxpayer's contention that an uninsured casualty loss to residential property is deductible from ordinary income.

In spite of these decisions the proper manner of deducting casualty losses still remains questionable. The IRS continues to hold that under the Treasury Regulations³⁷ a casualty loss to residential property is an involuntary conversion whether or not property or money is received as compensation, and is therefore deductible from capital gains under section 1231. As a result of this reasoning, the IRS has stated it will not follow the decision of the *Maurer* case.³⁸

The court in *Maurer* felt that the regulation was merely an attempt to distinguish involuntary conversions from uncompensated casualty losses. It stated as dictum that while the regulation should not be declared invalid, its proper application should be restricted to compensated involuntary conversions.³⁹ The persuasive reasoning of the courts seems to present the better solution to this question. As a result, uncompensated casualty losses to residential property should be allowed as a deduction from ordinary income under section 165, while casualty losses compensated for by insurance should be treated as involuntary conversions under section 1231.⁴⁰

A further complexity is introduced when one considers the effect of major damage to the apartment building, or even its total destruction.⁴¹ Assuming that the condominium building has been only

34. *Id.* at 124.

35. 230 F. Supp. 989 (E.D. Tenn. 1964).

36. *Id.* at 990-91.

37. Treas. Reg. 1.1231-1(e)(i) (1957).

38. Rev. Rul. 61-54, 1961-1 CUM. BULL. 398.

39. 284 F.2d at 124.

40. See 5 CCH 1965 STAND. FED. TAX REP. ¶ 4729.012.

41. The FHA Model Statute provides in the event of damage or destruction to all or part of the building, a vote should be taken among the condominium owners to decide whether to repair or rebuild. If within a certain number of days an agreement

partially destroyed and a decision to rebuild has been made, owners whose apartments have been damaged will be allowed a deduction for their uninsured casualty loss. In the event special assessments must be made to defray the costs of reconstructing common areas, all the owners may deduct their proportionate share of the assessment as previously described.

Should damage to the building be in excess of the statutory limit requiring reconstruction and the condominium owners vote not to rebuild, the proper allowance of the casualty loss deduction becomes more difficult. Assume that a large high rise condominium has been destroyed by fire in excess of the statutory limit, yet a few units have survived the holocaust unscathed. In the absence of adequate proceeds from fire insurance, it is quite likely that some of the owners will vote not to rebuild. The condominium owners will then become tenants in common of the entire project, suit for partition will be granted, and the available proceeds distributed proportionately among the owners. Again, those owners whose units were actually destroyed by the fire will be allowed a casualty loss deduction. But what treatment should be afforded to the owners whose units survived the disaster? These units, untouched by the fire, conceivably could have remained habitable until the building was razed as a result of the vote not to rebuild. Is their destruction a result of the fire and therefore deductible as a casualty loss?

The owners' loss of the undamaged units is a result both of the fire and of the decision not to rebuild. The power of the condominium owners to make this decision is granted by statute. Therefore, their decision to forbid reconstruction has the effect of law. This situation is analogous to cases where a fire insurer's liability is affected by statutes prohibiting reconstruction of a building after it has been severely damaged by fire. Where public authorities acting under a statute have required the demolition of a partially burned building, or forbidden its reconstruction, the owner of the insured building has been allowed recovery for his total loss, rather than limited to recovery only for that portion of the building which was burned.⁴² These eminently sensible decisions recognize that the statutory re-

to rebuild cannot be reached, the property is considered to be owned in common by all the condominium owners. The property then is subject to suit for partition in accordance with each unit owner's proportionate interest. *FHA MODEL STATUTE* § 26.

The Model Statute makes sufficient provision for disposition of the building after heavy damage, but fails to protect those owners who desire to retain their apartments when the building has been only partially destroyed. Other legislation has provided this protection by requiring mandatory reconstruction if two-thirds or less of the building is destroyed. If the damage exceeds two-thirds the value of the building, only an unanimous vote by the condominium owners can compel reconstruction. *E.g.*, *ARK. STAT. ANN.* § 50-1021 (Supp. 1963); *TENN. CODE ANN.* § 64-2718 (Supp. 1964).

42. Annot., 90 A.L.R. 2d 790 (1963).

quirement of demolition, or refusal to rebuild, is just as much a consequence of the fire as if the entire building had been consumed by the flames.

Following this reasoning, it would seem that the owners of the undamaged units should be allowed a casualty loss deduction from ordinary income for their loss caused by the condominium organization's exercise of its statutory power to forbid reconstruction. Undoubtedly the IRS would contend, as it did in the *Maurer* case, that the loss is an involuntary conversion within the meaning of the regulations and deductible only from capital gains. If the demolition of the undamaged units is treated as an involuntary conversion, the result may be to allow their owners only a deduction from capital gains, while the owners of the units which were actually burned will be allowed a deduction from ordinary income. Such a result would be inequitable; all the unit owners in the destroyed building should be afforded the same casualty loss deduction under section 165.⁴³

While a condominium owner has the advantage of some form of casualty loss deduction, this relief is not available to a tenant-stockholder in a cooperative apartment. The cooperative's loss may be passed on to the tenant-stockholder who then is limited to a capital loss under the worthless securities rule of section 165(g).⁴⁴

D. Deduction for Depreciation of Rental Property

If the condominium owner converts his unit into rental property, he may be entitled to a deduction for its depreciation. Section 167(a)(2) of the Code allows a deduction for depreciation due to exhaustion, wear and tear of property held for the production of income.⁴⁵ A similar deduction is available under section 167(a)(1) if the condominium owner uses his unit in his trade or business. In the past a tenant-stockholder in a cooperative was not allowed a deduction for depreciation if he rented his apartment to another person.⁴⁶ However, section 216(c) of the Code now allows this deduction to a tenant-stockholder.⁴⁷

A condominium owner who sells his occupied rental unit at a loss may also be entitled to a deduction under section 165(c)(1). This section allows a deduction to an individual taxpayer for losses incurred in his trade or business. Real estate rented as a trade or

43. Junius B. Peake, 10 CCH Tax Ct. Mem. 577 (1951) (taxpayer limited to long-term capital loss since interest consisted of stock, not a proprietary lease).

44. See 2 CCH 1965 STAND. FED. TAX REP. ¶ 1715.511.

45. Rev. Rul. 61-162, 1961-2 CUM. BULL. 48.

46. See note 20 *supra*; Treas. Reg. § 1.216-2 (1964).

47. 2 CCH 1965 STAND. FED. TAX REP. ¶ 1576.

business is not a capital asset;⁴⁸ loss on the sale of such property will not be limited to a capital loss, but may be deducted from ordinary income as a business loss.⁴⁹ However, it is questionable whether the rental of a single unit can be considered a "trade or business."⁵⁰ If the rental property meets this qualification, a deduction for casualty loss would also be available under this section if the property is damaged.⁵¹

II. TAXATION OF THE MANAGEMENT BODY

Legislation generally requires certain by-laws to be established by the condominium organization to govern administration of its property.⁵² The by-laws specifically provide for the administration, repair and maintenance of common areas; the method of collecting special assessments from individual owners; and the establishment of a management body to administer these provisions.⁵³ In carrying out its administrative duties, the management body may derive some form of taxable income from the rental of ground floor common areas to commercial enterprises,⁵⁴ the rental of an apartment unit acquired under a right of first refusal option,⁵⁵ the accumulation of reserves in its budget for operating expenses, or other sources. The procedure for taxing this income is doubtful. It may be taxed proportionately among the owners as tenants in common, or the management body may be considered a corporation and taxed accordingly. The latter possibility would present adverse consequences to the condominium organization since it would impose a double tax on the individual members.

To determine if the management body is an association taxable as a corporation, certain of its characteristics must be analyzed.⁵⁶ Two

48. Treas. Reg. ¶ 1.165-9(6)(1) (1960).

49. Correspondingly, any gain would be ordinary income.

50. *Compare*, Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954), *aff'd mem.*, 218 F.2d 603 (2d Cir. 1955) (rental of a single residence not a "trade or business"), *with* Leland Hazard, 7 T.C. 372 No. 8690 (July 16, 1946). See generally 5 CCH 1965 STAND. FED. TAX REP. ¶ 4729.51.

51. Treas. Reg. § 1.165-9(b)(3) (1960).

52. FHA MODEL STATUTE § 18.

53. FHA MODEL STATUTE § 19.

54. Note, 18 VAND. L. REV. 1773 (1965).

55. *Ibid.*

56. There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: "(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 An 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." Treas. Reg. § 301.7701-2(a)(1) (1960).

of these characteristics, associates and an objective to carry on business for joint profit, are essential to any organization in business for profit. If either of these characteristics is missing, the management body will not be taxed as an association.⁵⁷ The management body will obviously have associates since it is a creation of the by-laws established by all the condominium owners.

The regulations offer no definite guidelines for defining the term "an objective to carry on business for joint profit." Undoubtedly the management body will realize some profit from the sources previously mentioned, regardless of any attempt to minimize its amount. While it may be argued that the management body exists merely to effectuate the efficient use of common areas to reduce operating expenses, its purpose also is to contract with third parties, provide funds for contingencies, and rent real property.⁵⁸ These functions, considered together with the realization of profit, would seem sufficient to declare the management body has an objective to carry on business for joint profit.

The regulations provide that "an organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member"⁵⁹ will not cause its dissolution, and if no member has the power to dissolve the organization. None of these conditions, if suffered by a unit owner, will cause dissolution of the condominium organization. The provisions of the declaration, and by-laws as covenants running with the land⁶⁰ give continuity to the organization. A condominium organization normally will be dissolved only upon destruction of the building.

The existence of centralization of management is more difficult to determine in a condominium organization. The regulations state that an organization has centralization of management if it has the "continuing exclusive authority"⁶¹ to make independent business decisions without ratification by the organization's members. The regulations further provide there is no centralization of management when the management body merely acts as an agent at the direction of a principal.⁶² It seems implicit from the by-laws that the management body is subject to the will of the majority of the condominium owners. While it is true that the management body conducts all business for the condominium organization, its course of action will obviously be closely scrutinized by the owners. This degree of control

57. Treas. Reg. § 301.7701-2(a)(2) (1960).

58. Comment, 14 *HASTINGS L.J.* 270, 275 (1963).

59. Treas. Reg. § 301.7701-2(b) (1960).

60. *FHA MODEL STATUTE* § 12.

61. Treas. Reg. § 301.7701-2(c)(1) (1960).

62. Treas. Reg. § 301.7701-2(c)(3) (1960).

should be manifested in the by-laws by requiring the owners to ratify certain major transactions undertaken by the management body. This provision will establish the formal control of the owners without unduly hampering the normal conduct of business. However, in a large high rise condominium with its multitude of owners, even the device of ratifying major transactions may prove too burdensome for both the owners and management body. A large condominium will, therefore, be more likely to have centralization of management than will a smaller condominium due to the unwieldiness of close control by a large number of owners.

While the regulations provide that an unincorporated organization will be taxed as an association if it possesses certain legal relationships, the existence of these relationships is determined by local law.⁶³ This may be important in determining if the owners are subject to unlimited liability for obligations incurred by the management body.⁶⁴ Normally, all the condominium owners will be jointly and severally liable for contractual and tort obligations of the management body.⁶⁵

It is inherent in the concept of condominium ownership that each owner may freely transfer his interest subject only to the organization's option of first refusal. The regulations state that a first refusal option will not deny free transferability. The characteristic will still exist, but in a modified form which will be accorded less significance.⁶⁶

In retrospect, it can be seen that the management body of a condominium will probably have the following characteristics: associates, a profit objective, and continuity of life. Free transferability of interests will also exist in a modified form. Centralization of management may exist depending upon the number of owners and provisions of the by-laws. Finally, the management body will not have the characteristic of limited liability.

Since associates and a profit objective are characteristics common to both a partnership and a corporation, they will not be considered in determining whether the management body should be taxed as a

63. Treas. Reg. § 301.7701-1(c) (1960); 15 AM. JUR. 2d *Condominiums* § 19 (1964).

64. Florida limits the unit owner's liability for common expenses incurred by the management body. Also, the unit owner is not liable for damages caused by the management body in common areas. FLA. STAT. ANN. § 711.18 (Supp. 1964).

65. Tort liability incurred as a result of unsafe conditions in a common area, or by acts of the management body's employees, may inflict a severe burden on an owner. Even though an owner sued individually may be entitled to contribution, the expenses of defending the lawsuit and of obtaining contribution from other owners may be financially unbearable. However, the unit owner in this situation may receive some assistance if an indemnity agreement is incorporated into the declaration. See generally PROSSER, TORTS §§ 57-63 (3d ed. 1964).

66. Treas. Reg. § 301.7701-2(e)(2) (1960).

corporation or partnership.⁶⁷ However, it appears that the management body will still possess sufficient characteristics to be considered an association. Even if a strict numerical test is not applied in weighing the effect of these characteristics, one feels the result will be the same. Without intricate operating procedures to eliminate centralized management, the management body will probably possess all of the characteristics except limited liability. Therefore, only by proving the lack of a profit objective may the management body escape being taxed as an association—this may be difficult to do.

Assuming the management body to be taxable as an association, it then becomes important to consider methods of reducing the amount of taxable income. Generally, income will be provided from assessments of the owners and rental of common areas. Profits resulting from over-assessments may be reduced by closely relating the assessments to anticipated expenditures. If necessary, the by-laws should expressly provide that excess assessments must be refunded at the end of the year. On the other hand, if funds run short, a special assessment may be made to cover the deficit. In this manner the management body's accounts at the end of the year will show little or no profits resulting from over assessment. Assessments placed in a reserve fund⁶⁸ for future capital expenditures will probably avoid taxation since they may be considered contributions to capital.⁶⁹ However, a reserve fund for operating expenses may be considered taxable income since assessments paid into it might not be treated as capital contributions.⁷⁰

Minimizing the net profits from rental income may be more difficult. In a typical situation this income will be used to reduce assessments for operating expenses required of the unit owners. The problem is whether the management body will be able to minimize the amount of taxable income from rents by deducting the amount of its operating expenses.

In *Anaheim Union Water Co. v. Commissioner*,⁷¹ a nonprofit water cooperative sold water to its shareholders, and also received income from other unrelated sources. The water charges to the shareholders were reduced below cost by an amount equal to the non-water income. The net result was that the cooperative showed no profit, since its cost of supplying water to the shareholders was equal to its total income. The court held that the cooperative's showing of no profit was correct since it was entitled to deduct its entire amount

67. Treas. Reg. § 301.7701-2(a)(3) (1960).

68. See note 32 *supra*.

69. INT. REV. CODE OF 1954, § 118(a).

70. Treas. Reg. § 1.118-1 (1956).

71. 321 F.2d 253 (9th Cir. 1963).

of water costs as a business expense under section 162 of the Code.

The water cooperative in this situation seems analogous to a condominium management body which receives income from rental of common areas. Following the court's reasoning in *Anaheim*, it appears that the management body should be allowed to deduct expenses of operating the condominium from the rental income it receives, thus reducing its taxable income.

However, the individual unit owner's reduced assessment may be treated as a constructive dividend.⁷² This amount may be partially offset when the unit owner depreciates his proportionate share of income-producing sections of the common area.⁷³

The unit owners' problem of income derived from the rental of common areas, could be eliminated completely by selling the common areas as separate units of the condominium.⁷⁴

III. CONCLUSION

The deductions commonly available to a home owner will also be available to a condominium unit owner. The exact amount and method of taking a casualty loss deduction remains questionable, yet it will be allowed in some form. The aggregate amount of these deductions may well make condominium ownership more attractive than apartment rental. While most of these deductions have been made available to a tenant-stockholder in a cooperative, the condominium owner still occupies an attractive position since the cooperative owner's deductions are uncertain and difficult to calculate.⁷⁵

A condominium organization which does not rent common areas may escape taxation by careful control of unit owner's assessments. If common areas are rented, the organization may be taxed as a corporation since it will then be difficult to show the absence of a profit objective. As a result, it would seem wise, particularly for a large condominium, to incorporate in order to at least provide unit

72. The *Anaheim* case did not discuss the problem of a constructive dividend. However, income is constructively received by a taxpayer when it is credited to his account. Treas. Reg. § 1.451-2 (1957). See generally BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 134-38 (1959).

73. INT. REV. CODE OF 1954, § 167.

74. It has been suggested the federal government should provide mortgage insurance to small businesses wishing to buy a unit in a condominium. This would assist small business and encourage development of mixed condominiums in both urban and suburban business area. Berger, *Condominium: Shelter on a Statutory Foundation*, 63 COLUM. L. REV. 987, 1025-26 (1963).

75. Armstrong & Collins, *Condominium-The Magic in a Word*, 1964 So. CALIF. TAX INST. 667, 671-72. In addition to the difficulty in computing a tenant-stockholder's deduction, the taxpayer must also qualify under § 216 of the Code. See Whitebook, *The Cooperative Apartment*, 9 PRAC. LAW 25, 41-43 (1963).

owners with limited liability.⁷⁶ By using rental income to reduce assessments, the management body may avoid showing an appreciable amount of taxable profits. The reduced assessments will, however, result in a constructive dividend to the unit owners. The exact tax liability of the management body will unfortunately remain questionable until the IRS takes a definitive position.

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76. The unit owner's liability may be limited by statute. See note 64 *supra*. However, in the absence of this statutory protection the condominium organization will have to incorporate. The added expenses of incorporation seem small compared to the advantages of limited liability.