1974

Multi-Use Condominiums: Tax Planning to Avoid Double Taxation of Outside Income.

Michael Madison
Fordham University School of Law

MULTI-USE CONDOMINIUMS: TAX PLANNING TO AVOID DOUBLE TAXATION OF OUTSIDE INCOME

MICHAEL T. MADISON*

Condominiums[1] have become an increasingly popular method[2] of combining the convenience of apartment rental with the psychic satisfaction and tax benefits[3] of homeownership, particularly in urban areas where the scarcity of economically desirable land necessitates more intensive land use and places individual ownership of a detached home beyond the economic reach of many families. Notwithstanding this increasing popularity, certain problems inhere in the condominium form of ownership since, in the typical condomi-

*A.B., George Washington University; J.D., Harvard Law School; LL.M., New York University. Associate Professor of Law, The College of William and Mary.

1. "Condominium" is a Latin word meaning joint ownership or control. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 473 (1969). When applied to housing, the term connotes individual fee ownership of one or more units of air space in a multi-unit structure together with a proportionate undivided interest in the land and other common areas and facilities that serve the structure. These common areas and facilities, which are owned in common with other unit owners, include areas such as hallways, parking facilities, heating plants, recreational areas, and commercial facilities.

2. According to the National Association of Home Builders, condominiums accounted for 20 to 30 percent of "for sale built homes" in 1972. Boley, *Foreward* to C. NORCROSS, TOWNHOUSES AND CONDOMINIUMS: RESIDENTS' LIKES AND DISLIKES at 1 (1973). It is anticipated that approximately one-half of the population of the United States will be living in condominiums within the next two decades. DEP'T OF HOUSING AND URBAN DEVELOPMENT, QUESTIONS ABOUT CONDOMINIUMS 3 (1974).

3. The condominium unit owner, as a homeowner, is entitled to several tax benefits that are not available to a taxpayer who merely rents his residence, including: deduction for payment of local property taxes, INT. REV. CODE OF 1954, § 164(a)(1); deduction for mortgage interest paid, *id.* § 163(a); depreciation deduction if the residence is converted to rental property, *id.* § 167; deduction for casualty losses not reimbursed by insurance, *id.* § 165; postponement of recognition of gain on the sale of the unit if it is the seller's principal residence, *id.* § 1034; exclusion of realized gain from the taxable income of elderly taxpayers upon the sale of the unit, *id.* § 121. *See* Rev. Rul. 64-31, 1964-1 CUM. BULL. 300.

In addition, the proposed Tax Reform Act of 1973 included a Limitation on Artificial Accounting Losses that, if enacted, would induce developer-builders to favor condominiums over rental projects. Under present law, new residential rental structures may be depreciated at the maximum accelerated rates, using either the 200 percent declining balance or the sum-of-the-years-digits methods, INT. REV. CODE OF 1954, § 167(j)(2). Builders commonly sell such projects to syndicates comprising limited partners who can use the artificial tax losses generated by accelerated depreciation to shelter ordinary income from other sources. Under the proposed scheme, annual accelerated depreciation deductions may not exceed net related income; any excess must be deferred until there is sufficient offsetting net related income available. Interest and taxes paid during construction, however, still could be deducted from unrelated income. House Ways and Means Comm. Press Release No. 12 (June 12, 1974); 6 P-H 1974 FED. TAXES ¶ 60,310. Real estate syndications probably would wane in number if this tax reform measure were to be enacted.

nium, maintenance of the common areas is the responsibility of an unincorporated or incorporated association of unit owners. Funds to pay for the upkeep of the common areas are raised through assessments levied upon individual unit owners, and frequently a portion of the common areas is rented to commercial tenants, to provide income that can defray, at least partially, the costs of maintaining the residential common areas, while also providing residents with readily accessible sources of needed goods and services.

The benefits of such a common areas rental arrangement for the unit owner, however, may be lessened by serious tax and non-tax problems. Outside rental income used to defray residential maintenance expense may be taxable income both to the association and to the individual unit owner. A concomitant non-tax problem, especially if the association is unincorporated, is the potential exposure of the unit owners to unlimited tort and contract liability arising from operation of the common areas. Athough a variety of methods exists to limit the civil liability exposure of unit owners and even to remove one layer of the double taxation, it appears that vesting title to the common areas in a developer-owned corporation may provide a means for avoiding all taxation of rental income while also solving the problem of the unit owners' exposure to civil liability. Preferable to adjustment of the ownership entity, however, would be congressional action to remove the tax penalty on a popular and socially desirable type of housing.

THE CONDOMINIUM: AN OVERVIEW

An examination of the statutory framework governing condominium ownership is necessary to understand the specific tax and non-tax issues to be considered. Particular emphasis must be placed on the nature of the common areas, since they form the focal point for the proposed method of minimizing unit owner assessment while eliminating tax liability.

Condominium development is encouraged by section 234 of the National Housing Act of 1961,[4] which authorizes the Federal Housing Administration (FHA) to insure both permanent and construction mortgages on condominium projects in states that allow the condominium type of ownership. To establish guidelines for state legislation that would satisfy the requirements of section 234 and yet allow necessary local law modification, the FHA drafted a model

4. 12 U.S.C. § 1715y (1970).

statute.[5] This model statute typifies the enabling statute in force in every state, although variations exist in most statutes.[6]

The typical statutory scheme establishes a legal structure based on several organizational documents. A declaration or masterdeed, recordation of which establishes the condominium as a legal entity, usually contains such project-identification information as a description and allocation of the common areas and facilities, the floor plans, and the legal descriptions of the land, buildings, and individual units.[7] Bylaws are required to control the internal management of the condominium,[8] to provide rules for the management of the common areas, and to establish the means for collecting a pro rata share of the common expenses from the unit owners.[9] The third organizational instrument is the deed, by which the interest in each unit, along with an appurtenant interest in the common areas, is conveyed to each unit owner.[10]

Each unit owner is entitled to an undivided interest in the common areas,[11] inseparable from his apartment ownership, in a percen-

5. FHA MODEL CONDOMINIUM ACT (1962) [hereinafter cited as MODEL CONDOMINIUM ACT].

6. For the verbatim text and comparative analyses of the FHA Model Act and the state statutes, see 1 & 2 A. FERRER & K. STECHER, LAW OF CONDOMINIUM (1967).

7. Section 11 of the FHA Model Act requires the declaration to describe the common areas and facilities and to provide for the "[v]alue of the property and of each apartment, and the percentage of undivided interest in the common areas and facilities appertaining to each apartment and its owner for all purposes, including voting."

8. The bylaws ordinarily should provide for the election of officers and members of an executive committee who will manage the daily affairs of the condominium on behalf of all unit owners. 1 A. FERRER & K. STECHER, *supra* note 6, § 7.

9. The FHA Model Act suggests that the bylaws address the following subjects:

> (f) Maintenance, repair and replacement of the common areas and facilities and payments therefor, including the method of approving payment vouchers.
>
> (g) Manner of collecting from the apartment owners their share of the common expenses.
>
> (h) Designation and removal of personnel necessary for the maintenance, repair and replacement of the common areas and facilities.
>
> (i) Method of adopting and of amending administrative rules and regulations governing the details of the operation and use of the common areas and facilities.

MODEL CONDOMINIUM ACT § 19.

10. The FHA Model Act requires the deed to specify the percentage of undivided interest in the common areas to which the unit owner is entitled. *Id.* §12.

11. For a comprehensive examination of the operational and legal aspects of the common areas, see 1 P. ROHAN & M. RESKIN, CONDOMINIUM LAW AND PRACTICE § 6 (1974); 1 A. FERRER & K. STECHER, *supra* note 6, §§ 431-40, 451-54, 471-76, 491-97. The common areas may be divided into two distinct categories: general common areas and limited common areas. The general common areas are available for use by all unit owners and include such elements as the underlying land, yards, gardens, garbage incinerators and other utility equipment, swimming pools, golf courses and other recreational facilities, and the building's foundation, lobby,

tage set forth in the declaration.[12] The percentage ordinarily is a ratio of the value of the apartment unit to the value of the entire condominium property,[13] and the unit owner's voting power and his share of the common areas profits and expenses generally are based upon this percentage.[14] Each unit owner owns his share of the common areas as a tenant in common,[15] but since occupancy would be untenable without free access to all the general common areas, partition of these areas is prohibited.[16]

An association of unit owners generally is responsible for management and maintenance of the common areas,[17] and a large project often can be cared for practicably only by collective action by the unit owners. In the absence of statutory limitation of liability,[18] this management control of the common elements may result in contractual liability for the unit owners as principals on all authorized contracts of the unincorporated association,[19] while liability for un-

---

basement, and other structural components—generally, all structures and facilities existing for common use. *See* MODEL CONDOMINIUM ACT § 2(f). The limited common areas are available only for use by more than one but less than all unit owners and may include such elements as elevators, stairways, and balconies. Stores, offices, and other commercial or recreational facilities leased to outsiders also may be included in the common areas.

12. MODEL CONDOMINIUM ACT § 6(a).

13. *Id.*

14. *Id.* § 10. The Model Act defines "common profits" as "the balance of all income, rents, profits and revenues from the common areas and facilities remaining after the deduction of the common expenses." *Id.* § 2(h). "Common expenses" are the "expenses of administration, maintenance, repair or replacement of the common areas and facilities." *Id.* § 2(g). Such expenditures are funded by assessments by the association against the unit owners or by other income derived from the common areas, such as rental income from commercial tenants; they may include outlays for salaries, utilities for the common areas, services, professional fees, insurance, equipment, and supplies.

If the condominium consists essentially of only one type of unit, with only minimal differences among the unit owners' interests in the common elements, it may be more feasible to allocate one vote and an equal share of the common areas profits and expenses to each unit. Most statutes permit this variation by providing that profits and expenses are to be allocated as determined in the declaration or bylaws. *See, e.g.*, FLA. STAT. ANN. § 711.14 (1969); OHIO REV. CODE ANN. § 5311.08 (Page 1970). *See generally* P. ROHAN & M. RESKIN, *supra* note 11, § 6.03(1).

15. P. ROHAN & M. RESKIN, *supra* note 11, § 5.02.

16. *See, e.g.*, MD. ANN. CODE REAL PROP. § 11-107(a) (Supp. 1974); N.Y. REAL PROP. LAW § 339-mi(3) (McKinney 1968); VA. CODE ANN. § 55-79.55(g) (Supp. 1974).

The FHA 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 convenant to the contrary shall be null and void." MODEL CONDOMINIUM ACT § 6(c).

17. *See, e.g.*, MD. ANN. CODE REAL PROP. § 11-109 (Supp. 1974); N.Y. REAL PROP. LAW § 339-v(1)(a) (McKinney 1968). *See generally* P. ROHAN & M. RESKIN, *supra* note 11, § 6.02(3).

18. For an example of a statute limiting liability, see FLA. STAT. ANN. § 711.18(2) (1974).

19. *See* P. ROHAN & M. RESKIN, *supra* note 11, § 6.03(2).

authorized contracts may be based on apparent authority.[20] Incorporation of the association, if permitted under local law, might not alleviate this potential liability, since the corporation could be construed as the agent of the owners of the common areas, enabling liability to be predicated upon the unit owners' status as undisclosed or partially disclosed principals.[21]

There is also a risk of unlimited tort liability, absent statutory limitation,[22] for injuries to nonresidents caused by defective construction or maintenance of the common areas since each unit owner would have a duty of care to keep the common areas safe;[23] vicarious liability also could arise for the torts of employees of the association committed within the scope of employment.[24] Although the procurement of adequate liability insurance could ease this burden, condominium insurance is a new field with many unresolved problems.[25] Moreover, such insurance is expensive and of course still leaves the unit owners exposed if the policy is allowed to lapse or if a judgment is recovered in excess of the policy limits.

Greatly detracting from the condominium's desirability are the often excessive and unanticipated assessments that the unit owners must pay to maintain and manage the common areas. In a highly competitive market, developers sometimes will lure buyers by understating estimated assessments.[26] Even once the true costs are established, they can escalate because of inflation, self-dealing by manager-developers before the unit owners association assumes management duties,[27] or inefficient owner management once the association is in control.[28] Consequently, the owners may pay

20. *See id. See also* RESTATEMENT (SECOND) OF AGENCY § 159 (1957).

21. *See* RESTATEMENT (SECOND) OF AGENCY §§ 144, 186 (1957).

22. For an example of a statute limiting the unit owner's tort liability, see FLA. STAT. ANN. § 711.18(2) (1974).

23. *See* W. PROSSER, TORTS §§ 57-63 (4th ed. 1971).

24. *Id.* § 70.

25. *See* Note, *Condominiums: Incorporation of the Common Elements—A Proposal,* 23 VAND. L. REV. 321, 338-53 (1970).

26. *See* N.Y. Times, June 2, 1974, § 1, at 1, col. 7. Assessments to cover "hidden" costs often will increase by as much as 35 percent, and in some cases 50 to 60 percent, over the original estimates. R. SHELDON, KNOW THE INS AND OUTS OF CONDOMINIUM BUYING 40 (1973).

27. Condominium statutes may permit the developer to control the common areas for a limited time or until most of the units are sold. *E.g.,* VA. CODE ANN. § 55-79.74 (Supp. 1974). Occasionally, a developer will manage the common areas himself during this period or secure a long-term management contract with an insider and, in either case, charge an excessive rate of compensation. The statute might require unit-owner ratification of such long-term contracts initiated by the developer, however. *E.g., id.* §§ 55-79.74(b) (Supp. 1974).

28. The unit owners' association can engage the services of a professional manager and avoid the costs and inefficiency of owner management; a nonprofessional board often does

monthly assessments that, when added to property tax and mortgage payments, equal or exceed monthly rentals paid by neighbors in comparable buildings.

To reduce the impact of these assessments, several methods have been devised to generate income from outside sources that can be used to fund expenses for management and maintenance of the portions of the common areas devoted to residential use. For example, outsiders may be charged for the privilege of using condominium services or facilities, or concession income can be obtained from suppliers of services to condominium residents. Perhaps more popular is the leasing of space in the common areas to commercial tenants, providing a flow of rental income that can help to decrease or even offset completely the financial burden of maintaining the residential common areas.[29] Moreover, by leasing space to commercial tenants such as grocers, barbers, and pharmacists, the unit owners in such "multi-use" condominiums benefit from the proximity of desired services.

Use of rent from commercial common areas to reduce assessments involves an inherent tax problem, however, that can undercut the desirability of "assessment-free" condominium ownership: the net income from outside sources used to defray maintenance assessments may constitute taxable income both to the unit owners' association and to the individual unit owners. The following discussion will demonstrate the severity of this possibility and will present a tax planning technique that can be used not only to prevent double taxation of this outside income, but also to avoid or minimize single taxation as well.

Double Taxation: A Vexing Burden

This double taxation problem can be illustrated by use of a hypothetical situation. If a multiple-use condominium, managed by an unincorporated unit owners' association, has annual residential common areas expenses of $100,000, the unit owners can defray at least part of these expenditures by leasing space at an annual cost

not devote the time necessary for proper careful management, and it may not have the requisite experience to handle efficiently matters such as local assessments, taxes, insurance, zoning ordinances, and hiring and supervising of personnel. In addition, a professional management concern, which also manages other properties, often can purchase utility services at cheaper bulk rates. Moreover, experience has shown that occupants and commercial tenants meet their obligations more punctually when dealing with professionals. *See* A. FERRER & K. STECHER, *supra* note 6, § 472.

29. *Id.* § 431, at 300 n.2.

to themselves of $50,000 to commercial tenants who will pay $100,000 annual rent. The unit owners thus must pay a total of only $50,000 in assessments, since the net rental income ($50,000) will pay for one-half of the residential common areas expenses.[30]

The Internal Revenue Service could seek to characterize this activity by the unit owners as a partnership for federal income tax purposes, claiming that the unit owners concertedly are conducting a business for profit by leasing the common areas.[31] If the unit owners are treated as partners, the net commercial income ($50,000) would be taxable to them as ordinary income although it is not distributed but is rather used to pay for maintenance of the residential common areas.[32] Partnership status could be avoided by leasing to the commercial tenents on a "net-lease" basis, whereby no services would be provided to the tenants by the owners.[33] But even if partnership status is avoided, the unit owners would still be taxed as tenants in common on their pro rata shares of net commercial income, and thus the only advantage of a net lease agreement in this situation would be the ability to use general tax advantages available to tenants in common but not to partners.[34]

Even worse for the unit owners, however, is the specter of double taxation raised by the possibility that the group of unit owners, whether partners or tenants in common, may be treated as an association taxable as a corporation.[35] In this case, the net outside in-

30. Of course, in addition to these assessments, the unit owners must pay for utilities furnished to their individual units, while also making nondeductible mortgage amortization payments. Mortgage interest payments and separately assessed shares of local property taxes, however, would be deductible from the unit owner's income for federal tax purposes. INT. REV. CODE OF 1954, §§ 163, 164. If the unit is used for income producing purposes, the costs of utilities and depreciation also would be deductible. *Id.* §§ 162, 167.

31. *See* Treas. Reg. § 1.761-1(a) (1972). Treas. Reg. § 1.761-1(a) provides in part: "The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Code . . . . Tenants in common . . . may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if co-owners of an apartment building lease space and, in addition, provide services to the occupants either directly or through an agent."

32. INT. REV. CODE OF 1954, § 702(a)(9). The constructive partnership presumably would not be able to use the maximum accelerated depreciation rates when computing taxable income, since the commercial common areas would not be "residential rental housing." *See id.* § 167(j)(1) (2).

33. *See* Treas. Reg. § 1.761-1(a) (1972).

34. For example, unlike partners, tenants in common are not required to file an information return. *See* INT. REV. CODE OF 1954, § 6031.

35. *See* notes 38-39 *infra* & accompanying text.

come of $50,000 would be taxed twice: upon receipt, the net income would be taxable to the constructive corporation, and, when the income inures to the unit owners' economic benefit by reducing maintenance assessments that they otherwise would have to pay, it would be taxable as a constructive dividend. Such double taxation would be predicated upon the assumption that the commercial common areas have been deemed transferred to the taxable association; otherwise, the commercial income could not be imputed to the association.[36] Charging the association with this income would, of course, entitle it to deductions for income-related expenses, including depreciation.[37]

To be treated as a taxable association subject to a second layer of tax liability two prerequisites must be met. First, the unit owners must constitute a group of associates with "an objective to carry on business and divide the gains therefrom . . . ."[38] Second, the group must be tainted with three or more of the corporate attributes of continuity of life, centralization of management, limited liability of members, or free transferability of membership interests.[39]

Arguably, the commercial common areas in this case are being leased for the nonbusiness purpose of reducing residential assessments while assuring the availability of convenient commercial services, rather than for the purpose of engaging in a profitable venture. The purpose of the business objective requirement, however, apparently is to distinguish among various types of profit-making entities, such as corporations and trusts; these distinctions do not necessarily mean that associations engaging in a nonprofit, and thus "nonbusiness," activity never can be taxed as a corporation.[40]

36. This view is in accord with that of at least one commentator. *See* Anderson, *Tax Aspects of Cooperative and Condominium Housing,* N.Y.U. 25TH INST. ON FED. TAX. 79, 95 (1967).

37. It has been suggested that the status of the depreciation deduction is uncertain since the unit owners' association actually does not own the commercial common areas. P. ROHAN & M. RESKIN, *supra* note 11, § 15.06(3). The unit owners, as members of the association, also would not be entitled to the deduction, which only could be used to offset income of the association. *Id.* But if the association constructively owns the commercial common areas for income taxing purposes, then it would be inconsistent to disallow the deduction because the association is not the record owner.

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

39. *See id.* § 301.7701-2(a).

40. *See* Rev. Rul. 74-319, 1974 INT. REV. BULL. No. 27, at 10.

The organization under consideration in Revenue Ruling 74-319 consisted of franchised dealers who had established a fund administered by the franchisor, and to which each dealer contributed, for the purpose of financing a national campaign to advertise franchisor's

Assuming, therefore, that the business objective test is satisfied, taxable association status still could be avoided by drafting the condominium instruments and structuring the unit owners' activities so that at least two of the tainted corporate attributes are absent. Limited liability of the association's members undoubtedly would be absent, since there is no corporate shield to protect the unit owners from civil liability.[41] Continuity of the association's existence, however, seems assured, since neither death, insanity, or bankruptcy of a unit owner, nor sale of his unit will, under typical condominium declarations or bylaws, cause dissolution of the association.[42] Therefore, either centralized management or free alienability of membership interest must be eliminated to guarantee noncorporate tax treatment.

Centralized management is present when the management group has "exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members."[43] Elimination of this attribute, by requiring unit owner ratification of each decision, undoubtedly would be impracticable, especially in a large condominium with many units.[44] Free transferability of interests could be eliminated by requiring transfers of units to be approved in advance by the remaining unit owners. Limiting alienability in this way, however, undoubtedly would reduce the marketability of condominium units. A less onerous alternative that apparently would suffice would be to prevent, by bylaw provision, a new unit owner from participating in the management of the association without the other members' consent,[45] although right of

---

product. It was held that this organization constituted a taxable entity. In reaching this conclusion, the ruling noted that the regulations under section 7701 "were developed without reference to, and do not definitely cover, unincorporated organizations (other than trusts) that are engaged in not-for-profit activities." *Id.* at 11.

41. *See* Treas. Reg. § 301.7701-2(d) (1965). *See* notes 18-25 *supra* & accompanying text.

42. *See* Treas. Reg. § 301.7701-2(b) (1965).

43. *Id.* § 301.7701-2(c)(3).

44. Perhaps centralized management could be eliminated by providing in the bylaws that all management decisions are considered presumptively ratified unless a fixed percentage of unit owners object, in which event the matter would be decided by the entire group.

45. Treasury regulations provide:

> An organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member. . . . In order for this power . . . to exist . . . the member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization. . . . [T]he characteristic of

first refusal in the remaining owners would not be sufficient by itself to eliminate the free transferability taint.[46] The impracticality of removing sufficient corporate attributes, from a business organization or marketing standpoint, has led to a search for solutions to the double taxation dilemma. Even if taxable association status is avoided, moreover, the unit owners still would be taxed on the ordinary income realized as partners or tenants in common on their pro rata share of the net commercial income.

One possible solution, to alleviate the uncertainties of taxable association status, would be incorporation by the unit owners' association, to provide a corporate entity that can handle the common areas problems.[47] Each unit owner would lease his share of the commonly owned property to the commonly owned corporation, setting the rent at an amount equivalent to his pro rata share of the rentals received from outside tenants. By eliminating the corporation's net income, double taxation can be avoided. The ordinary rental income realized by the individual unit owner would be offset to some extent by deductions for taxes, interest, and a proportionate share of the depreciation of the common areas.[48] Because the corporation and the unit owners are related entities, however, the IRS may reallocate their income and deductions under section 482 of the Internal Revenue Code of 1954.[49] In addition, single taxation of the unit owners has not been eliminated or minimized.

Another possibility is use of the cooperative form of ownership.[50] Under section 216 of the Code,[51] each tenant-shareholder in a housing cooperative may deduct his proportionate share of the property tax and mortgage interest expenditures,[52] but only the corporation may deduct these items when they relate to the common areas.[53]

> free transferability of interests does not exist in a case in which each member can, without the consent of other members, assign only his right to share in profits but cannot so assign his rights to participate in the management of the organization.

Treas. Reg. § 301.7701-2(e)(1) (1965).

46. *Id.* § 301.7701-2(e)(2).

47. *See* Anderson, *supra* note 36, at 97-98.

48. Presumably, depreciation could be taken only on the portion of the common areas devoted to commercial use. *See* INT. REV. CODE OF 1954, § 167.

49. *Id.* § 482.

50. In the cooperative form of housing, unlike the condominium, the apartment building is owned by a corporation, the stockholders of which are the building's tenants. Ownership of stock in the corporation confers a proprietary interest in an apartment unit.

51. INT. REV. CODE OF 1954, § 216.

52. *Id.* § 216(a)(1)-(2). If the residential unit is leased or otherwise used for business or income production purposes by the tenant-shareholder, a deduction for depreciation may be taken. *Id.* § 216(c).

53. *See* Treas. Reg. § 1.216-1(b) (1971).

Additionally, the tenant-shareholders are immune from contract and tort liability arising from activities of the corporation. But while section 216 allows a cooperative housing corporation to receive up to 20 percent of its gross income from outside sources,[54] use of this income to offset shareholder-related expenses might well be deemed a constructive dividend.[55] Thus, neither double nor single taxation is eliminated to the extent that net commercial income is used to defray residential common areas expenses.

The cooperative also poses several non-tax problems not associated with the condominium. For example, because the corporation holds legal title to the land and buildings, only the corporation is liable for property taxes and it alone can procure a mortgage. Consequently, the entire cooperative structure is saddled with a blanket mortgage and single tax assessment; default by one occupant on his share results in a default that must be cured by the others to prevent foreclosure of the mortgage or tax lien. Moreover, the tenant-shareholder, holding merely a leasehold estate, may not alienate his interest without approval by the board of directors,[56] and his interest is subject to a right of entry reserved in the lessor-corporation.[57]

THE DEVELOPER-CORPORATION AS OWNER OF THE COMMON AREAS: A SOLUTION

The inability of the foregoing alternatives to protect condominium unit owners against unlimited tort and contract liability while providing a flow of income, free from the burdens of single or double taxation, to finance residential common areas expenses does not mean the problem is insolvable. Two possibilities remain: a unit owner-controlled corporation that would own the common areas *ab initio*, or a similar corporation controlled by the developer. Either of these alternatives can provide unit owners the desired protection if four conditions are met. First, the plan must be allowed by local

54. INT. REV. CODE OF 1954, § 216(b)(1)(D).

55. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.05, at 7-27 (3d ed. 1971); *cf.* Fruit Growers' Supply Co. v. Commissioner, 56 F.2d 90 (9th Cir. 1932) (nonmember outside income held separable from membership income of farmers' cooperative and thus could not be used to increase tax-free membership patronage rebates); *accord,* Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326 (8th Cir. 1961). Because a cooperative housing corporation is taxed as a cooperative under INT. REV. CODE OF 1954, §§ 1381-88 (Park Place, Inc., 57 T.C. 767 (1972)), its outside income apparently could not be used to offset shareholder-member expenses and thereby reduce its taxable income.

56. 1 AMERICAN LAW OF PROPERTY § 3.10 (A.J. Casner ed. 1952).

57. *See id.*

law. Second, the expenditures by the corporation for the upkeep of the residential common areas must be "ordinary and necessary" within the meaning of section 162 of the Internal Revenue Code.[58] Third, the expenditures must be incurred "in carrying on [a] trade or business" within the meaning of section 162.[59] Finally, the use of residential common areas expenses in excess of unit owner assessments to offset net income from outside sources must not be prohibited by section 277 of the Code.[60] A detailed examination of these questions will indicate the ability of the proposed solution to reach the desired objectives.

Feasibility of Common Areas Corporation Under Local Law

While existing condominium statutes prohibit unit owners from conveying their common areas interests,[61] there is apparently no statutory prohibition against ownership *ab initio* by another entity. For example, section 2(f) of the FHA Model Act defines the common areas to include certain specific elements "[u]nless otherwise provided in the Declaration or lawful amendments thereto."[62] Section 6(a) merely provides that each unit owner is entitled to an interest in the common areas "in the percentage expressed in the Declaration."[63] Hence, it would appear that an entity other than the unit owners as tenants in common, such as a corporation controlled by the unit owners or the developer, could own *ab initio* the common elements pursuant to original or perhaps amendatory[64] language in

58. INT. REV. CODE OF 1954, § 162(a) provides in pertinent part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred in carrying on any trade or business . . . ."

59. *Id.*

60. *Id.* § 277. For the text of section 277, see note 115 *infra*.

61. *See* note 16 *supra* & accompanying text.

62. MODEL CONDOMINIUM ACT § 2(f). At least a majority of state statutes have language identical or similar to the language contained in section 2(f). *E.g.*, CONN. GEN. STAT. ANN. § 47-68(f) (Supp. 1974); N.Y. REAL PROP. LAW § 339-e (McKinney 1968). Others contain similar language but omit the "unless otherwise provided" clause. *E.g.*, KY. REV. STAT. § 381.810(7) (1972); ARIZ. REV. STAT. ANN. § 33-551 (1974). At least one statute is internally inconsistent, implying that the common areas are defined by the condominium instruments (*see* VA. CODE ANN. § 55-79.50 (Supp. 1974)), while also implying that the ownership of the common areas shall be allocated to the unit owners (*see id.* § 55-79.55).

63. MODEL CONDOMINIUM ACT § 6(a).

64. An attempt to amend the declaration to vest title to the common elements retroactively in the corporation, might be prohibited by Section 6(c) of the Model Act, which prohibits any conveyance of the common areas. Section 6(b), however, suggests that an amended declaration, duly recorded, can change the percentages of ownership interest in the common areas.

the declaration.[65] Only a few states expressly permit the unit owners' association to incorporate,[66] but evidently no state explicitly prohibits this organizational form. Although condominium statutes generally provide that the association of unit owners is responsible for the management and maintenance of the common areas,[67] both the nature of the common areas and the powers of the association are defined and controlled by the declaration and bylaws.[68]

"Ordinary and Necessary"

Once the non-tax problem of incorporation is resolved, a series of tax hurdles must be overcome. The first involves characterization of expenditures of the corporation for maintenance of the common areas as "ordinary and necessary," to bring the outlays within the realm of allowable business expense deductions under section 162 of the Code. If a deduction is allowed, the excess of the expenses over unit owner assessments can be deducted from the net income from outside sources, producing the desired "washout" of income effect. In the example presented earlier,[69] the portion of total residential common areas expenses ($100,000) to be paid by unit owner assessments was $50,000, with the other $50,000 being funded by the net income from leasing the commercial common areas. If, unlike the original example, the common areas were owned by an entity separate from the unit owners, this entity, the common areas corporation, would seek to deduct its $50,000 residential common areas expenditure from its $50,000 net rental income, leaving it with no

65. One commentator has suggested that amendment of state statutes is desirable to clarify the power of a unit-owner-controlled corporation to hold title to the common areas. Note, *Condominiums: Incorporation of the Common Elements—A Proposal,* 23 VAND. L. Rev. 321, 333 (1970). However, there is no reasoning or authority offered in support of this conclusion. Moreover, the condominium statute in one leading state expressly permits the unit owner's interest in the common areas to be in the form of a leasehold. *See* N.Y. REAL PROP. LAW § 339-3(5) (McKinney Supp. 1974). *See also* Ackerman v. Spring Lake of Broward, Inc., 260 So. 2d 264 (Fla. Ct. App. 1972) (no violation of condominium statute where unit owner's interest in recreational common elements is undivided share of 99-year leasehold).

66. At least nine jurisdictions expressly permit incorporation: CONN. GEN. STAT. ANN. § 47-89 (1974); FLA. STAT. ANN. § 711-12 (1969); IDAHO CODE § 55-1506 (Supp. 1974); IND. ANN. STAT. § 32-1-6-8 (1974); IOWA CODE ANN. § 499 B.2 (1971); MASS. GEN. LAWS ch. 183A, § 8(i) (1974); N.J. STAT. ANN. § 46:8A-27 (1971); N.C. GEN. STAT. § 47A-19(1) (1966); VA. CODE ANN. § 55-79.73 (Supp. 1974).

67. *See, e.g.,* ARIZ. REV. STAT. ANN. § 33-561 (1974); FLA. STAT. ANN. § 711.12(6) (1969); PA. STAT. ANN. tit. 68 §§ 700.306-07 (1965). *See generally* P. ROHAN & M. RESKIN, *supra* note 11, § 6.02(3), at 6-14.

68. *See* MODEL CONDOMINIUM ACT §§ 2(d)-(f).

69. *See* note 30 *supra* & accompanying text.

net income to be taxed and with no earnings and profits to support subsequent dividends. But, to be allowed as a trade or business deduction, an expense must be "ordinary and necessary"; several cases involving nonprofit membership organizations indicate the likelihood that such a deduction will be allowed, especially when the common areas corporation is owned by the developer rather than by the unit owners.

An attempt by a nonprofit membership organization to deduct excess expenses incurred in connection with membership activities from unrelated outside commercial income was confronted in *Anaheim Union Water Co. v. Commissioner.*[70] In *Anaheim* this attempt was successful even though the washout arrangement, unlike the current hypothetical arrangement,[71] was between related entities and was based more on form than substance. The case concerned a taxable nonprofit water cooperative that sold water to its shareholders, but which also received substantial income from sources unrelated to its water sales activity, thereby enabling the cooperative to reduce water charges to its shareholders below cost. Because the cost of supplying water to its members was equal to the combined income from membership charges and outside sources, the taxpayer earned no profits. The Commissioner contended that expenditures made for the production of water supplied to shareholders were not "ordinary" because the taxpayer did not recoup these expenses from water sales revenue.[72] In the alternative, the Commissioner argued that because the shareholders were obligated to pay the cost of furnishing the water, the non-water income used to discharge this obligation increased gross receipts from water sales to equal expenditures for water production, causing the non-water income to remain intact as net taxable income.[73]

The Court of Appeals for the Ninth Circuit rejected both arguments, noting that water expenditures in excess of receipts were ordinary expenses for Anaheim because its articles of incorporation and bylaws required such expenditures.[74] Moreover, the bylaws required the shareholders to pay only rates equal to the net cost rather

70. 321 F.2d 253 (9th Cir. 1963), *rev'g* 35 T.C. 1072 (1961).

71. If the unit owners themselves are not to control the common areas corporation in this hypothetical, the most likely alternative source of control would be the developer of the condominium.

See also notes 115-30 *infra* & accompanying text.

72. 321 F.2d at 253.

73. *Id.* at 259.

74. *Id.* at 258.

than the full cost of water supplied to them.[75] The court did not consider whether the shareholders received a constructive dividend in the form of below-cost water purchases. But if, as the court held, the company had no net income, it also could not have had current earnings and profits to generate a dividend.[76] Presumably, being a nonprofit organization, the taxpayer also had no accumulated earnings and profits to distribute.

A similar issue faced the Court of Appeals for the Seventh Circuit in *Chicago & Western Indiana Railroad v. Commissioner,*[77] in which a railroad cooperative, which owned extensive track and terminal facilities leased primarily by shareholder railroads, received outside income from concessions and privileges relating to its ownership of passenger stations. Pursuant to agreement, the shareholders were obligated to pay the costs of operating the common facilities, with the revenue from outside sources to be credited against the shareholders' rental obligations. As in *Anaheim,* the Commissioner claimed that the expenses incurred by the taxpayer to provide below-cost services to the shareholders were not ordinary and necessary business expenses. The court summarily accepted this argument, citing the Tax Court's holding in *Anaheim* in favor of the Commissioner as an indistinguishable case.[78]

Despite the appearance of conflicting holdings in *Chicago & Western Indiana* and *Anaheim,* the cases are at least somewhat distinguishable. The court in *Chicago & Western Indiana* reasoned that the cooperative, as an accrual basis taxpayer, had income equal to what it was entitled to receive under the leases with shareholders, rather than what it actually received from them,[79] applying the rudimentary tax accounting rule that an accrual basis taxpayer has earned income "when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."[80] Presumably, once the corporation is treated as having constructively received from its shareholders the agreed charge for the services rendered, the amounts of out-

75. *Id.*

76. For federal income taxation purposes, a dividend is "any distribution of property made by a corporation to its shareholders" out of "earnings and profits." INT. REV. CODE OF 1954, § 316. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.01-.05 (3d ed. 1971).

77. 303 F.2d 796 (7th Cir.), *vacated on rehearing,* 310 F.2d 380 (1962).

78. *Id.* at 801.

79. *Id.* at 800.

80. Treas. Reg. § 1.451-1(a) (1971).

side income credited to the shareholders' accounts would be treated as constructive dividends. In contrast, the shareholders in *Anaheim* were not obligated to pay the fixed costs of furnishing the water, but only the price of the water set by the taxpayer's board of directors, which equaled the net cost. Therefore, even if the taxpayer was an accrual basis taxpayer, no income could be deemed realized based merely on the gross charges for providing water, since these payments would never become due.[81]

Furthermore, in *Anaheim* the taxpayer was obligated by its corporate charter and bylaws to expend more for the services it rendered to its members than it was to receive in return, while the railroad

81. The result in *Chicago and Western Indiana* apparently prompted Congress in 1962 to enact section 281 of the Internal Revenue Code, to provide special relief for railroad terminal corporations, although the legislative history does not reveal explicit congressional reaction to the fundamental tax issue involved in that case and in *Anaheim*. *See* S. REP. No. 2273, 87th Cong., 2d Sess. (1962).

On rehearing, the Court of Appeals for the Seventh Circuit vacated its judgment in *Chicago and Western Indiana*, remanding the case for reconsideration based on Section 281. Chicago & W.I.R.R. v. Commissioner, 310 F.2d 380 (7th Cir. 1962). Because relief was accorded only to railroad terminal corporations, it might be inferred that Congress may have approved of the Tax Court's ruling in *Anaheim*; at the time of section 281's enactment, however, *Anaheim* was pending appeal in the Court of Appeals for the Ninth Circuit, and statutory relief thus would have been premature.

These two cases also led to the enactment in 1969 of Code section 277, which deals with nonprofit social clubs and other membership organizations. *See* notes 115-30 *infra* & accompanying text. S. REP. No. 91-552, 91st Cong., 1st Sess. (1969), illustrates the congressional intent:

> Certain nonexempt organizations which provide services to members on a nonprofit basis realize investment income or income from providing services to nonmembers, which is used to defray all or part of the cost of providing services to members. Some courts have held that taxable membership organizations cannot create a "loss" by supplying their members services at less than cost. Other courts have held, instead, that such a "loss" is permissible, and that the expenses of providing such services at less than cost offset for tax purposes additional income earned by the organization from investments or other activities.
>
> . . .In some cases, membership organizations, which also have business or investment income, serve their members at less than cost and offset this book loss against their business or investment income and as a result pay no income tax. In an important decision, it was held that a non-exempt water company was not subject to tax when the "losses" in supplying its members water offset its investment income. Other courts have held to the contrary.
>
> . . .Both the house bill and the committee's amendments provide that in the case of a taxable membership organization the deduction for expenses incurred in supplying services, facilities or goods to the members is to be allowed only to the extent of the income received from these members. The purpose is to prevent membership organizations from escaping tax on business or investment income by using this income to serve its members at less than cost and then deducting the book "loss".

Id. at 74.

cooperative members were required to pay the full costs of the services they received from the taxpayer unless offset by outside income. Arguably, the need for the water cooperative to comply with its charter and bylaw provisions, to avoid committing an ultra vires act, provides at least some substance to the arrangement, distinguishing it from what otherwise more easily might be characterized as a blatant tax avoidance scheme as in the railroad cooperative situation.

Although the argument raised by the Commissioner that expenses in excess of membership assessments are not ordinary and necessary apparently has been abandoned,[82] its application to the common areas corporation situation is instructive. Of course, some use of the drafting techniques that were successful in *Anaheim* might be desirable, including structuring the arrangement to require the common areas corporation to expend more for maintenance and management than it receives from the unit owners and not obligating unit owners to pay the gross costs of the services. But reliance on these drafting techniques alone may not be sufficient to avoid the "ordinary and necessary" problem.

Under section 162, expenditures incurred in the ordinary course of business are deductible unless shown otherwise; an expense normally will be considered "necessary" if it is "appropriate and helpful" in developing and maintaining the taxpayer's business.[83] Moreover, recognizing that a taxpayer is unlikely to incur an expenditure unless compelled to do so for business reasons, the courts are inclined to accede to the taxpayer's judgment of whether an expense is necessary.[84] Any determination of what is "ordinary and necessary" must be based on the nature and scope of the taxpayer's business.[85] Although a common areas corporation owned by the unit owners might meet the same difficulties that confronted the taxpayers in *Chicago & Western Indiana* and *Anaheim,* a developer-owned corporation logically could claim that the inducement of below-cost assessments is a reasonable expense to attract buyers in an increasingly competitive market. Such expenses undoubtedly would be "appropriate and helpful" to the development of the taxpayer's business, especially considering the highly competitive nature of the condominium sales market.

82. *See* notes 89-103 *infra* & accompanying text.

83. *See* Welch v. Helvering, 290 U.S. 111 (1933). *See generally* 4A J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 25.09 (1972).

84. *See* 4A J. MERTENS, *supra* note 83, at 44.

85. *See* Deputy v. Dupont, 308 U.S. 488, 496 (1940).

Indeed, the condominium arrangement has more economic substance than the bargain services rendered in *Anaheim,* where the Commissioner's "ordinary and necessary" argument was rejected. In *Anaheim,* the same economic result could have been achieved if the taxpayer had distributed the outside income to its members, who then would have been free to use this taxable dividend income to defray their water costs. This economic reality led the Commissioner to argue that, in substance, the taxpayer had net income that was distributed to the shareholders in the form of water for less than cost.[86] To allow a deduction for these expenditures would allow tax avoidance by mere manipulation of corporate documents. By way of analogy, the Commissioner could have argued that a corporate charter requiring income to be expended on recreational activities would not transform such nonprofit expenditures into deductible business expenses.[87] Likewise, if the director-shareholders of a close corporation are also employees, little weight ordinarily will be given to their resolution authorizing excessive salaries for themselves; rather, the excess payments probably will be treated as a dividend.[88]

When the reduced cost common areas maintenance arrangement is between two unrelated entities, however, as when the corporation is controlled by the developer, no tax avoidance purpose should be imputed to the corporate bylaw requirement that entitles the unit owners to below-cost common areas assessments since no taxable form exists to restructure the transaction to achieve the same economic result. The unit owners would have no direct or indirect proprietary right to the income from the commercial common areas because they are neither owners of the property nor shareholders in the developer-owned corporation. The only method, therefore, by which the unit owners can receive their bargain is in the form of reduced assessments, since direct receipt of income, or indirect receipt through dividend distribution in the form of cash or reduced-cost services, is precluded by the absence of any ownership interests in the common areas. While manipulation of the corporate financial structure should not always determine federal tax consequences, the Commissioner should not ignore the organizational framework when it reflects economic realities and a valid business purpose.

86. *See* 321 F.2d at 260.
87. *Cf.* International Trading Co. v. Commissioner, 275 F.2d 578 (7th Cir. 1960).
88. *See* Kerrigan Iron Works, 17 T.C. 566 (1951); Treas. Reg. §§ 1.162-7, 1.162-8 (1958).

"Trade or Business"

Overcoming the "ordinary and necessary" hurdle still leaves the "trade or business" obstacle to be negotiated by the common areas corporation. Although the court of appeals in *Anaheim* notably did not question whether the excess expenses there had been incurred "in carrying on any trade or business," as required by section 162,[89] the question could be raised if a common areas corporation were to provide the suggested bargain services to condominium unit owners. Several cases dealing with this issue, concerning pre-section 277 taxable years,[90] which now controls the issue for nonprofit membership organizations, indicate the probable result of this claim if raised in regard to a common areas corporation.

In *Bear Valley Mutual Water Co. v. Riddell,*[91] a case factually similar to *Anaheim,* the Government contended that a business expense deduction is part of the determination of net business income and therefore should be limited to expenses incurred in producing the income involved.[92] Furthermore, it was claimed that the basic motive behind any taxpayer's activities for which a business deduction is allowable must be to profit from those activities.[93] Therefore, although the taxpayer was engaged in profit-motivated activities from which income was derived, the water expenditures for shareholders in excess of assessments were not incurred in carrying on those activities, and hence should be nondeductible. Rather, the excess expenses were incurred to provide water to the taxpayer's members at less than full cost, a clearly nonprofit function. Instances were cited[94] in which business and nonbusiness activities are separated for deduction purposes, such as the requirement, for example, that exempt charitable and educational organizations pay tax on their separate "unrelated business taxable income."[95] In fact, the *Anaheim* approach largely would nullify the entire statutory

89. INT. REV. CODE OF 1954, § 162. The *Anaheim* court stated: "It is not disputed that Anaheim during 1952-54 was carring on a business — the furnishing and delivery of water to those of its shareholders who desired to purchase water." 321 F.2d at 258.

90. A proposed treasury regulation provides that Code section 277 apply to taxable years beginning after December 31, 1970. *See* Proposed Treas. Reg. § 1.277-1(a), 37 Fed. Reg. 9278 (1972).

91. 427 F.2d 713 (9th Cir. 1970).

92. Brief for Appellant at 22-24, Bear Valley Mut. Water Co. v. Riddell, 427 F.2d 713 (9th Cir. 1970).

93. *Id.* at 24-26.

94. *Id.* at 32-38.

95. INT. REV. CODE OF 1954, §§ 511-12.

exemption scheme for nonprofit organizations; a taxpayer desiring to offset business income with nonbusiness expenses could receive more favorable tax treatment if it was nonexempt. The Commissioner finally argued that the excess water costs were not expenses, but were, in fact, capital expenditures because they were incurred to deliver an asset, water, to shareholders. The cost of supplying the water, therefore, was an investment in an asset, necessarily capital in nature.[96] The Court of Appeals for the Ninth Circuit, however, rejected these arguments without discussion, because the facts before it were indistinguishable from those in *Anaheim*. The court did note that the problem had been dealt with by enactment of section 277, which would control subsequent similar cases.[97]

Adirondack League Club v. Commissioner[98] involved a nonprofit social membership organization that was organized, among other reasons, to maintain a fishing and hunting preserve for use by its members. The taxpayer sought to offset against income from timber operations on its property the excess expenses incurred in providing membership facilities and services. As in *Bear Valley*, the Commissioner abandoned his argument that the membership expenses in excess of dues were not ordinary and necessary and instead argued that the expenses were not incurred in carrying on any trade or business.[99] Responding to the taxpayer's argument that any corporate activity constitutes a trade or business as long as it achieves a corporate objective,[100] the Commissioner cited the so-called "hobby" cases in which profit-making corporations were not allowed to deduct from their bona fide trade or business profits losses suffered in unrelated nonprofit leisure activities.[101] The Tax Court sustained the Commissioner's contentions and the appellate court affirmed this ruling without discussing the "trade or business" issue.

Finally, in *Five Lakes Outing Club v. United States*,[102] the Court

96. Brief for Appellant at 42-44, Bear Valley Mut. Water Co. v. Riddell, 427 F.2d 713 (9th Cir. 1970).

97. 427 F.2d at 713.

98. 55 T.C. 796 (1971), *aff'd per curiam*, 458 F.2d 506 (2d Cir. 1972).

99. Brief for Appellee at 9-19, Adirondack League Club v. Commissioner, 458 F.2d 506 (2d Cir. 1972); Brief for Respondent at 13-38, Adirondack League Club v. Commissioner, 55 T.C. 796 (1971).

100. Brief for Appelant at 5-6, Adirondack League Club v. Commissioner, 458 F.2d 506 (2d Cir. 1972).

101. Brief for Appellee at 11-13, Adirondack League Club v. Commissioner, 458 F.2d 506 (2d Cir. 1972). *See, e.g.*, International Trading Co. v. Commissioner, 275 F.2d 578 (7th Cir. 1960); American Properties, Inc. v. Commissioner, 262 F.2d 150 (9th Cir. 1958).

102. 468 F.2d 443 (8th Cir. 1972), *rev'g* 71-2 U.S. Tax Cas. ¶ 9,735 (E.D. Ark. 1971). In

of Appeals for the Eighth Circuit held that expenses incurred to sustain nonprofit activities of an unincorporated social club could not be deducted from unrelated rental income. Because the recreational activities were not profit-motivated, the situation was viewed as analogous to the hobby cases.[103]

Would the common areas expenses in excess of unit owner assessments be sufficiently profit-motivated to withstand attack under the trade-or-business requirement? Although the issue is now expressly covered by code section 277[104] for membership organizations, conceivably precluding such an arrangement for a corporation owned by the benefited members, the answer for a developer-owned corporation is somewhat different. In both the cases prior to the enactment of section 277 and the analogous hobby cases, the courts have held that an overall profit motive is a prerequisite to deductibility and that the function of the business expense deduction is to determine net business income. In the pre-section 277 cases, no profit motive was present regarding the taxpayer's main nonprofit activities, and the net loss from these activities therefore could not be deducted from the taxpayer's unrelated business income. Similarly, in the hobby cases, although a profit-seeking corporation normally is deemed to be engaged in a trade or business, it cannot offset true business income with deductions based on unrelated recreational or leisure activity expenses. A corporation engaged in both business and nonbusiness activities therefore must separate the expenses incurred in each activity for purposes of a section 162 deduction.

Possibly, the common areas corporation could argue that its overall activity is profit-motivated, since an upward adjustment in rentals or a reduction of total expenses would result in a profit from this commercial activity. A more compelling argument, however, even if it is conceded that the purpose of the taxpayer's activities is to reduce unit owner assessments rather than to earn a profit, would be that the ultimate purpose of the bargain arrangement is to facilitate condominium sales in a competitive condominium market. The regulations promulgated under section 162 suggest that expenses of a loss operation are deductible if the taxpayer ultimately intends to

---

Iowa State Univ. of Science & Tech. v. United States, 74-2 U.S. Tax Cas. ¶ 9,590 (Ct. Cl. 1974), the Court of Claims also held that the taxpayer, a tax exempt state university, could not offset the excess non-profit-motivated expenses of its radio stations against its unrelated profit-motivated business income from its television stations under Code section 513.

103. 468 F.2d at 445.

104. *See* notes 115-30 *infra* & accompanying text.

make a profit.[105] In addition, in all the cases discussed above, with the possible exception of *Adirondack League Club*, there was no clear nexus between the profit and loss activities; here, the nexus between the developer's sales efforts and its symbiotic common areas activities is clear. Either activity would suffer without the other; without the bargain arrangement sales would drop, and without sufficient sales there might not be enough net commercial income to cover the costs of maintaining all the common areas, since a relatively vacant condominium would be unattractive to potential commercial tenants.

Profit-seeking corporations often engage in loss activities that nonetheless generate deductible expenses because they result in a direct business advantage to the taxpayer's profit-motivated activities. For example, rebates, patronage dividends, and discounts, which result in direct business advantages to the offeror, are considered part of the cost of selling and are deductible.[106] Also deductible are amounts paid by a parent corporation to its subsidiary to meet the latter's operating deficits if the parent's own sales are enhanced, although the payor and payee are separate tax entities.[107] A more direct analogy would be a seller of goods who engages in a loss operation, such as an oil company servicing at a discount the furnaces of its oil-purchasing customers. Certainly, the argument that the service expenses in excess of receipts are not legitimate business expenses of the taxpayer would be strained.

Perhaps the obviousness of this conclusion explains the absence of case law squarely on point. One recent case, however, *Mountain Lake Corp. v. United States*,[108] presented a problem closely analogous to the posited common areas corporation arrangement. The taxpayer, a profit-seeking corporation that sold residential lots and other real estate, also maintained a golf course, which it operated at a loss to attract purchasers of its residential lots. Because the golf course operation was so closely connected with the taxpayer's general business, the corporation was allowed to deduct golf course maintenance expenses in excess of golf course income. Distinguishing the case before it from *Adirondack League Club* and the hobby cases, the court found the excess expenses to be both ordinary and

105. *See* Treas. Reg. § 1.162-1(a) (1969).

106. 4A J. MERTENS, *supra* note 83, § 25.126.

107. *See, e.g.*, Fall River Gas Appliance Co., 42 T.C. 850 (1964), *aff'd*, 349 F.2d 515 (1965); 4A J. MERTENS, *supra* note 83, § 25.12, at 77.

108. 27 Am. Fed. Tax R.2d § 71-507 (M.D. Fla. 1971).

necessary and incurred in carrying on a trade or business.[109]

In *Adirondack League Club* the taxpayer argued that if its excess membership expenses were nondeductible because its membership activities were not profit-motivated, then it must follow that none of the membership expenses are deductible, resulting in the taxation of gross income.[110] The Commissioner, as a matter of administrative practice in the hobby cases, has allowed hobby expense deductions to the extent of income, thereby in effect allowing deductions for nonbusiness expenses to the extent they generate income.[111] Arguably, this practice is not inconsistent with the position that nonprofit expenses cannot offset unrelated business income, because both rules rest on the well-established principle that, to calculate net business income, gross business income can be reduced only by business-related expenses; in the hobby cases, it is nonbusiness income that may be offset by nonbusiness expenses, while in the membership organization cases, the effort was to deduct nonbusiness expenses from business income. Nevertheless, in the case of a common areas corporation controlled by the developer, the argument raised in *Adirondack League Club* would be more persuasive, since the income washout effect deriving from the taxpayer's common areas activities is instrumental to the production of revenue by the sale of condominiums.

It might be claimed, as the Commissioner contended in *Bear Valley*, that to allow the deduction of excess expenses would be inconsistent with, and indeed might jeopardize, the statutory exemption scheme for nonprofit organizations.[112] Although it is by no means clear that the types of organizations involved in the cases that have been discussed would qualify for exempt status under the Internal Revenue Code,[113] it is conceivable that the advantages of a rule as announced in *Anaheim* might induce a qualified organization to forgo the exempt status in order to avoid taxation of its unrelated business income.[114] But this argument, too, loses force when the taxpayer is a common areas corporation. A developer-

109. *Id.* at 71-988-89.

110. Brief for Petitioner at 13, Adirondack League Club v. Commissioner, 55 T.C. 796 (1971).

111. *See, e.g.*, International Trading Co. v. Commissioner, 275 F.2d 578 (7th Cir. 1960) (Commissioner permitted deduction of expenses of maintaining property that corporation held for nonbusiness purpose of benefiting shareholders to extent of income derived from such property).

112. Brief for Appellant at 38, Bear Valley Mut. Water Co. v. Riddell, 427 F.2d 713 (9th Cir. 1970).

113. *See* INT. REV. CODE OF 1954, § 501.

114. *See id.* §§ 501(b), 511.

controlled corporation, the business of which is selling real estate, hardly resembles the type of nonprofit organization eligible for exempt status under the Code; in this case, at least, no threat to the statutory scheme would exist.

Section 277

The foregoing analysis has dealt with case law concerning taxable years beginning prior to January 1971 because, as has been noted, the ability to deduct excess membership expenses from outside income has been circumscribed legislatively for later taxable years by the enactment of section 277 of the Internal Revenue Code.[115] Although this provision may forestall utilization of the washout of income proposal by a unit owner corporation, the practicability of a developer-controlled common areas corporation does not seem to be impaired.

An examination of the language of section 277 and the proposed regulations thereunder[116] does not indicate clearly whether the section and the regulations apply to a common areas corporation controlled by the unit owners. If the corporation were exempt from taxation, section 277 certainly would be inapplicable, since it is addressed only to organizations "not exempt from taxation."[117] The Service has ruled recently, however, that an organization formed by unit owners to provide for the management, maintenance, and care of the common areas of a condominium project, with membership assessments paid by the unit owners, does not qualify for exemption under section 501(c)(4),[118] because such organizations are for the private benefit of members rather than for the general welfare of the community.[119]

115. INT. REV. CODE OF 1954, § 277(a) provides:

> In the case of a social club or other membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members (including income derived during such year from institutes and trade shows which are primarily for the education of members). If for any taxable year such deductions exceed such income, the excess shall be treated as a deduction attributable to furnishing services, insurance, goods, or other items of value to members paid or incurred in the succeeding taxable year.

116. *See* Proposed Treas. Reg. § 1.277, 37 Fed. Reg. 9278 (1972).

117. INT. REV. CODE OF 1954, § 277(a).

118. *Id.* § 501(c)(4).

119. Rev. Rul. 74-17, 1974 INT. REV. BULL. No. 2, at 11.

If the non-exempt condominium management body were a profit or nonprofit cooperative corporation engaged in substantial non-shareholder activity, such as managing and maintaining the commercial common areas, neither section 277, which applies to "social club[s] or other membership organization[s] . . . operated primarily to furnish services or goods to members . . . ,"[120] nor any other Code section[121] expressly precludes offsetting outside income by excess residential common areas expenses. The regulations[122] and legislative history,[123] however, both indicate an intent to cover cooperatives, especially if they are nonprofit organizations. Consequently, it appears that a unit owner corporation, which owns the common areas, would be barred by section 277 from deducting expenses incurred to provide services to unit owners to the extent that such expenditures exceed unit owner assessments.

If, however, a corporation owning the common areas and selling the units were controlled by the developer, guaranteeing unit owner access to the common areas by contractual rights in the nature of a license, leasehold, or easement, section 277 would not appear to preclude a deduction for residential common area expenses in excess of income from unit owner assessments. Certainly, the arrangement would not be encompassed by the plain wording of section 277, which prohibits the washout effect only "[i]n the case of a social

---

120. INT. REV. CODE OF 1954, § 277(a).

121. Section 183 disallows deductions for nonprofit activities of individuals and electing small business corporations. *Id.* § 183. Sections 1381-88, dealing with taxation of cooperatives, do not address the issue. *Id.* §§ 1381-88. The deduction also is not expressly prohibited by section 162 or the authorities construing that section. *See* notes 58-59, 105 *supra* & accompanying text.

122. The language in regulations proposed to supplement section 277 is broad in scope: "The phrase 'social club or other membership organization which is operated primarily to furnish services, facilties, or goods to members . . .' means any taxable organization operated on a mutual, cooperative or similar basis whose primary activity is providing members with services, facilities, or goods. . . . [I]t is immaterial whether the organization is incorporated or unincorporated or is regarded as a profit or nonprofit corporation under applicable state law." Proposed Treas. Reg. § 1.277-1(b)(1), 37 Fed. Reg. 9278 (1972). These regulations also suggest that any cooperative organization could be regarded as a membership organization within the ambit of section 277 if any services are furnished to members. *See id.* § 1.277-1(c), ex. 1.

123. The Senate Finance Committee report concerning section 277 suggests that the primary objective of the drafters of that section was to prevent a nonprofit cooperative, like the taxpayer in *Anaheim,* from using outside income to serve its members at below cost rates. *See* note 81 *supra*. The Internal Revenue Service lists as a "prime issue" the question "[w]hether a non-profit corporation not exempt from tax may offset income from nonmember or nonshareholder sources against costs of operations for services rendered to members or shareholders." CCH 1974 STAND. FED. TAX REP. § 6632. Prime issues are those that the service ordinarily will insist on litigating.

club or other membership organization which is operated primarily to furnish services or goods to members . . . ."[124] A profit-motivated corporation owned by a condominium developer and operated primarily to sell condominium units would be furnishing services to outsider-customers, rather than insider-members, as a means of increasing its sales. Moreover, according to the regulations, such a corporation would not constitute a "membership organization" since it would be operated primarily to realize gains to be distributed to its shareholder, the developer.[125] The corporation conceivably could grant the unit owners a collective voice in the management of the common areas and yet not be regarded as a membership organization operating on a cooperative basis.[126] The unit owners must, it is true, sacrifice their right to ultimate control over the common areas, which otherwise would be theirs under typical condominium statutes; a primary purpose of that control, however, is to minimize assessments, an objective accomplished by the arrangement proposed. Because unit owner management often is quite inefficient and generally is more expensive than professional management,[127] the loss of control may be even more beneficial than the reduced assessments alone would indicate.[128]

---

124. INT. REV. CODE OF 1954, § 277(a).

125. Proposed Treas. Reg. § 1.277-1(b)(1), 37 Fed. Reg. 9278 (1972) provides: "An organization which is operated primarily to realize gains to be distributed among its shareholders in proportion to their capital investment or other equity interests is not a membership organization." *Cf.* Treas. Reg. § 1.456-5(c) (1967).

126. The terms "mutual" and "cooperative," although appearing in several Code provisions, apparently are not defined meaningfully by the Code or regulations. *See, e.g.*, INT. REV. CODE OF 1954, §§ 216, 1381-88, 7701(a). The proposed regulations under section 277 do confirm, however, that a profit corporation not owned and controlled by its "members" is not an organization furnishing services "on a mutual, cooperative or similar" basis:

> M Corporation was established by B to own and operate a golf club for individuals living in homes built by B. B established M to facilitate the sale of houses he built. B anticipates he will earn a profit on his investment in M. M's facilities are open only to individuals who buy his homes (its "members") and their dependents and guests. Although M's "members" have a voice in the operational policies of the golf club, all decisions are subject to the approval of B, who is the sole shareholder of M. Under these circumstances, M is not providing its members with services, facilities, or goods on a mutual, cooperative, or similar basis and is not, therefore, a membership organization for purposes of section 277 and this section.

Proposed Treas. Reg. §1.277-1(c), ex. 2, 37 Fed. Reg. 9279 (1972). *Cf.* Rev. Rul. 70-481, 1970-2 CUM. BULL. 170 (a corporation rendering certain services to its members at cost and making distributions to the members based on business with them is "operating on a cooperative basis" within the meaning of Code section 1381(a)(2)).

127. *See* note 28 *supra.*

128. Because the unit owners have contracted for perpetual use of the residential common

The scope of section 277 thus appears limited to a specific class of organizations, including only non-exempt cooperative and other membership organizations. This conclusion is substantiated by the section's legislative history,[129] which also does not imply that Congress necessarily regarded *Anaheim's* washout ruling as bad law.[130] Because a developer-owned common areas corporation therefore can provide to condominium unit owners the benefits of reduced assessments while avoiding the tax pitfalls of other proposals, an evaluation of the method's feasibility in light of other tax and non-tax considerations is warranted.

General Considerations

Various tax benefits of condominium ownership still would be available to unit owners in a condominium in which the common areas are owned by a developer-controlled corporation. For example, each unit owner would be entitled to a deduction for interest on his individual mortgage, the lien of which would cover his apartment unit and presumably his contractual right to use the common areas.[131] Depreciation, if the unit is used for income producing purposes, and property taxes allocable to the individual unit[132] also would be deductible expenses. Unlike the typical condominium arrangement, however, where title to the common areas is in the unit owners, only the common areas corporation could deduct depreciation and property tax expenses attributable to the common areas.[133]

areas, the Service might seek to characterize them as the true owners, in substance at least if not in form. *But cf.* Rev. Rul. 62-177, 1962-2 Cum. Bull. 89 (tenant-stockholders of a cooperative housing corporation which leased land and an apartment building erected thereon are not entitled to a deduction under section 216 for their proportionate share of real estate taxes on the building, even though the building's estimated useful life is substantially shorter than the term of the lease). But, in fact, the developer, not the unit owners, has ultimate control of the common areas. Furthermore, under the proposed scheme the developer presumably would be entitled to a management fee if he provides the management services; if outside management is used, the developer undoubtedly would retain a share of the net profits from the commercial common areas as compensation for the risks and expenses that normally accompany ownership of real property. These features make the developer's control more than formalistic.

129. *See* note 81 *supra*.

130. The Senate Finance Committee's report stated that the adoption of section 277 was not intended "to create any inference as to the allowability under existing law of a deduction for the excess of such costs over income from members." S. Rep. No. 91-552, 91st Cong., 1st Sess. 2104 (1969).

131. *See* Rev. Rul. 64-31, 1964-1 Cum. Bull. 300.

132. Condominium statutes generally provide that each apartment unit shall be deemed a separate entity for local tax assessment purposes. *See, e.g.*, Model Condominium Act § 22.

133. Because the common areas corporation, and not the unit owners, owns the common

If the condominium is used as the unit owner's principal residence, postponement of recognition of gain on the sale of the unit would be allowed.[134] Finally, the unit owner would be entitled to an uninsured casualty loss deduction relating to his residential unit.[135] Casualty losses to the common areas, not compensated by insurance, would provide an ordinary business loss deduction for the common areas corporation.[136]

If the developer-controlled common areas corporation seeks to recover its costs incurred in construction of the common areas, plus a margin of profit, at the time of sale rather than over the useful life of the common areas improvements, additional gain arguably would be realized at that time. If the developer initially charged the purchaser the full purchase price, including an amount allocable to the contract right to use the common areas, the Service might contend that, because the developer has retained fee ownership of the

---

areas, it would be the taxpayer upon whom taxes are imposed, and who thus would be entitled to deductions. Treas. Reg. § 1.164-1(a) (1964).

134. INT. REV. CODE OF 1954, § 1034. Certainly the benefits of section 1034 would be available to the portion of the purchase price allocable to the residential unit. *See* Rev. Rul. 64-31, 1964-1 CUM. BULL. 300. The Service may claim, however, that a portion of the purchase price is allocable to the appurtenant contract right to use the common areas. This right undoubtedly is valuable, and because it is inseparable from the fee title to the residential unit, the policy of section 1034 should encompass this additional aspect of the entire residential bargain. That the right is a chose in action rather than residential property should not prevent the section's application. *Cf.* INT. REV. CODE OF 1954, § 1034(f) (cooperative housing corporation stock qualifies for nonrecognition treatment). Similar treatment would seem applicable for unit owners aged 65 or over under section 121. *See id.* § 121(d)(3).

135. *See* INT. REV. CODE OF 1954, § 165(c)(3).

136. In a traditional condominium arrangement the unit owners, as owners of the common areas, would be entitled to casualty loss deductions, spread proportionately among the unit owners. The net effect of apportioning the deduction would reduce the total deduction by $100 per unit owner. *See* INT. REV. CODE OF 1954, § 165(c)(3); Note, *Condominium and Cooperative Housing: Taxation by State and Federal Governments*, 21 U. FLA. L. REV. 529, 531 (1969).

Arguably, both the unit owners and the corporation could take a deduction under the proposed scheme. If the common areas were partially destroyed, the unit owners would demand, under the terms of the contract, that the corporation restore the premises. But if the entire common areas were destroyed, with the corporation having no obligation to rebuild, the unit owners might claim to be the equitable owners of the common areas, thus also entitled to a deduction. The unit owners also might claim that their contract right to use the common areas suddenly has become worthless, and, but for the physical destruction, this property interest would be valuable. For an examination of the requirements of section 165(c)(3), see 3 J. RABKIN & M. JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION §§ 41.03(1),(3) (1974). Because the corporation and the unit owners are separate entities, both having a "property" interest in the common areas, double deduction logically should be allowed. *Cf.* Junius Peake, 20 P-H Tax Ct. Mem. ¶ 51,181 (1951) (cooperative housing corporation can deduct business losses while shareholders may take a worthless stock deduction). The Service, however, might argue that the unit owners' contract rights have no real basis and that the loss deduction cannot exceed basis. *See* Treas. Reg. § 1.165-7(b) (1964).

common areas, the developer's basis in this portion of the project cannot be used to offset any of the amount realized. Hence, additional ordinary gain would be realized to the extent that the common areas basis was not allowed to reduce gross income. To avoid such incremental gain in the year of sale, however, the developer could charge the unit owner only an amount sufficient to recoup its costs attributable to the apartment unit, plus a profit; the costs and profit allocable to the common areas then could be recovered by charging each unit owner his pro rata share, amortized over the useful life of the improvements. This amount would be in the nature of an additional rental, and it would be analogous to a sale-leaseback rental, which is set at a level that allows the purchaser-lessor to recover his capital expenditures, plus a rate of return to compensate him for the use of his capital, over the leaseback period.[137] In effect, part of the purchase price would be deferred and financed by the common areas corporation, which, as any lender-lessor, would be taxed on its income when it is received over the payout period.

An important aspect of the proposed condominium arrangement is its impact on the unit owners' ability to obtain adequate mortgage financing. Under typical condominium ownership arrangements, the unit owner's mortgage gives the lender a lien on both the fee simple interest in the residential unit and the unit owner's fractional undivided fee interest in the common areas. Although the common areas may represent a significant portion of the project's total value, obviously no interest in them could be conveyed by the unit owner when title to the common areas is held by a common areas corporation. Under the proposed arrangement, however, the unit owners would have a contractual right to unlimited use of the common areas, a right which would be alienable and which would accompany any transfer of the unit owner's interest in the property, assuming adequate provisions were incorporated into the condominium and mortgage instruments. The lender could include the contractual right to use of the common areas under the lien of its mortgage, while assuring that the contract itself permits the mortgagee or a purchaser at foreclosure to succeed to the unit owner's interest in the common areas. Because these precautions should

137. For a general discussion of the sale-leaseback method of financing, see Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations*, 62 HARV. L. REV. 1 (1948). The purchaser-lessor in the typical sale-leaseback arrangement will require rental payments that enable him to recover capital outlay plus an adequate rate of return over the leaseback term. *Id.* at 4.

guarantee to the mortgagee the same rights that are represented by the unit owner's interest in the common areas under the normal condominium arrangement, lenders should not be discouraged from granting mortgage loans equivalent in amount to those normally available to condominium unit owners.

The lender's chief concern may be that poor management of the common areas can result in permissive waste, greatly depreciating the value of the individual residential units, the value of which depends at least in part on the rights to use adequate common areas facilities.[138] This risk ordinarily is present in any condominium project because the unit owners have only derivative management control through their membership in the unit owners' association. Because the unit owners could be given a similar degree of control by their contracts with the common areas corporation, the risk of permissive waste would be no greater in the proposed arrangement. Indeed, the risk may be obviated to a great extent because of the perhaps greater likelihood of professional management when the common areas are owned by a developer-controlled corporation. In either case, the mortgagee could receive an equivalent degree of protection by providing in the mortgage for acceleration of the debt and foreclosure in the event of excessive waste to the common areas.

Vesting ownership of the common areas in a developer-controlled corporation also would protect the unit owners from the potential contract and tort liability to which they are subject in the typical condominium development. Having no proprietary interest in the common areas, the unit owners could not be subjected to direct or indirect liability stemming from activities relating to those areas. Assuming that the developer-controlled corporation is adequately managed and capitalized, the developer, as shareholder, also would be protected from personal liability.

LEGISLATION: A BETTER SOLUTION

Although the feasibility of a common areas corporation to prevent undue income tax liability for owners of residential condominium units has been demonstrated, it cannot be gainsaid that a more certain and perhaps less contrived solution is needed. A recent flurry of activity in Congress concerning taxation of condominiums indicates that this need has not gone unnoticed. No less than 11

138. *See* Berger, *Condominium on a Statutory Foundation*, 63 COLUM. L. REV. 987, 1000 (1963); Kerr, *Problems of Mortgage Lender*, 11 PRAC. LAW. 55 (1965).

bills, evidencing a variety of solutions, were introduced in the 93d Congress to exempt condominium management bodies from taxation.[139]

Some of the proposed measures exhibit features that would impair greatly their overall desirability to unit owners and developers seeking to maximize their tax and non-tax advantages. For example, two of the bills would not permit incorporation of the association,[140] thereby rendering the choice between tax exemption and limited civil liability mutually exclusive. Others would restrict[141] or deny[142] exempt status to multi-use condominiums, effectively limiting the ability to earn outside income that can be used to offset residential common areas maintenance expenses. Some bills, by restricting the association's ability to make distributions, conceivably could prohibit constructive distributions to the unit owners in the form of reduced assessments.[143]

139. *See* S. 3786, 93d Cong., 2d Sess. (1974); S. 3663, 93d Cong., 2d Sess. (1974); H.R. 16226, 93d Cong., 2d Sess. (1974); H.R. 16100, 93d Cong., 2d Sess. (1974); H.R. 15693, 93d Cong., 2d Sess. (1974); H.R. 15396, 93d Cong., 2d Sess. (1974); H.R. 15367, 93d Cong., 2d Sess. (1974); H.R. 15313, 93d Cong., 2d Sess. (1974); H.R. 15174, 93d Cong., 2d Sess. (1974); H.R. 15166, 93d Cong., 2d Sess. (1974); H.R. 14630, 93d Cong., 2d Sess. (1974).

These bills do not address only double taxation that may arise from receipt of rentals from commercial tenants in a multi-use condominium since double taxation of condominiums may arise more frequently in other contexts. For example, even though the corporation will determine common areas assessments in accordance with anticipated expenses, budget surpluses sometimes occur; these over-assessments will be income and part of the corporation's earnings and profits. (This problem already has been mitigated somewhat by a ruling that provides tax-free status to excess assessments if they, in effect, are returned to the unit owners in the form of reduced assessments the following year. *See* Rev. Rul. 70-604, 1970-2 Cum. Bull. 9.)

Double taxation also may be threatened under the common practice by which the condominium corporation sets aside a portion of its assessments in a reserve for future improvements and replacements; since there may be no current offsetting expenses, these amounts could be treated as taxable income. This problem is aggravated when the unit owners own the common areas, thus precluding the corporation from taking a depreciation deduction. Moreover, the investment income from these accumulated reserves likewise may be taxed, and the use of these funds to maintain the common areas may be deemed a constructive dividend to the unit owners if they also own the common areas.

140. *See* H.R. 15693, 93d Cong., 2d Sess. (1974); H.R. 15174, 93d Cong., 2d Sess. (1974).

141. *See, e.g.*, H.R. 14630, 93d Cong., 2d Sess. (1974) (not exempt if outside income exceeds 20 percent of gross income). Two bills would disallow the exemption for rental income that is generally available to exempt organizations, Int. Rev. Code of 1954, § 512(b)(3). *See* H.R. 16100, 93d Cong., 2d Sess. (1974); H.R. 15166, 93d Cong., 2d Sess. (1974). The absence of a rent exemption clearly would prevent the non-taxable use of outside rental income to reduce unit owner assessments.

142. *See, e.g.*, H.R. 15166, 93d Cong., 2d Sess. (1974) (exemption limited to associations "operated exclusively for the preservation, maintenance, and management of the common areas and facilities of the condominium . . . owned by such association or its members and *used for noncommercial purposes* . . . ." (emphasis supplied)).

143. *See, e.g.*, H.R. 16100, 93d Cong., 2d Sess. (1974).

A bill introduced by Senators Beall and Mathias[144] appears to provide the most relief for unit owners, and it is most consistent with the tax planning device proposed in this Article. Any nonprofit condominium membership corporation or organization that is "operated exclusively" to manage and maintain the common areas would be exempt if "no part of [its] net earnings . . . inures (other than through the performance of related services for the members . . .) to the benefit of any member of such corporation or organization or other person."[145] Assuming that the "operated exclusively" requirement would not preclude leasing part of the common areas, the net income from commercial tenants could be used to defray residential common areas expenses and yet not jeopardize the tax-exempt status of the unit owners' association. Moreover, the ability to incorporate the management body, with ownership of the common areas vested in that body, would allow the unit owners to eliminate their potential tort and contract liability.

Legislative action, with its potential certainty, undoubtedly provides the best means of avoiding double taxation of condominium developments. The recent congressional action in this regard is indeed encouraging. Until legislative relief is available, however, a properly planned condominium arrangement can provide the same, albeit less certain, relief. By vesting title to the condominium's common areas in a corporation owned by the developer, space leased to commercial tenants can provide a flow of income to be used to defray at least some of the maintenance expenses of the residential common areas. Because these expenses exceed that portion of the corporation's income received from unit owner assessments, it may be possible to object that they were not incurred as ordinary and necessary expenses in the carrying on of a trade or business; such an attack would seek to prohibit the deduction of these expenses from the net income received by the corporation from outside sources. Because the ability to deduct these expenses, and thereby to offer prospective residential purchasers reduced assessments, gives the developer an additional selling point in the highly competitive condominium sales market, however, the residential maintenance expenses should be tax deductible as business expenses.

The popularity of condominiums certainly has not peaked; moreover, the continued development of this housing form, desirable for its space economies in times of dwindling land resources, should not

144. *See* S. 3663, 93d Cong., 2d Sess. (1974).
145. *Id.* § 1.

be impeded by tax disadvantages not found in other modes of housing. Double taxation of outside income used to defray common areas expenses in multi-use condominiums poses such a threat, while also discouraging the leasing of condominium space to commercial tenants who can provide convenient services for residents. The owner of a detached dwelling is not taxed doubly on income he uses to maintain and improve his dwelling, yet the potential taxable association status of multi-use condominium management bodies would yield this additional tax burden. If a desirable form of housing is not to be discouraged, the burden of double taxation should be removed.