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COMMERCIAL AND INDUSTRIAL CONDOMINIUMS: AN OVERALL ANALYSIS‡

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During the past decade, hundreds of thousands of residential condominium units have been marketed in the United States. Several reliable observers estimate that condominiums now represent 10 to 20 percent of all new housing starts in many metropolitan areas. The rapid growth of residential condominiums has overshadowed the pioneering efforts of several developers in the area of industrial, commercial and multiple-use condominiums. In recent months, however, these innovative projects have begun to make their appearance in ever-increasing numbers.

Among these commercial and industrial condominium projects are motels, hotels, office buildings, industrial parks, shopping centers, professional offices, and combination buildings featuring offices or retail stores on the lower floors and residential units on the upper floors. In some instances, a savings and loan association has created a condominium, reserving the lower floors for its own purposes, while marketing the floors above to the general public. Where residential properties have been constructed as condominiums with first floor stores, restaurants, and other commercial facilities, or converted to condominium status, the developer frequently retains the commercial condominium units. In some instances, the owner might have considered converting the property to cooperative status, but may have been prevented from doing so by the so-called “eighty-twenty” test of section 216 of the Internal Revenue Code which, in effect, deprives a residential cooperative of its tax deductions if more than 20 percent of its income is from commercial sources.¹

† This article is adapted from Chapter 21 of P. ROHAN & M. RESKIN, CONDOMINIUM LAW AND PRACTICE and two articles, by Mr. Shapiro, appearing in the July and August 1974 issues of the JOURNAL OF TAXATION, entitled Commercial Condominiums: Significant Tax Benefits Possible if Properly Structured and Commercial Condominiums: Tax Considerations for Unit Purchasers and the Association. The authors wish to acknowledge the substantial contribution made by B. Harrison Frankel, Esq., of the New York Bar, to the thoughts contained in this article.

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¹ Int. Rev. Code of 1954, § 216. The prescript of the statute is to give a residential
More recently, commercial and industrial condominiums have been formulated that are devoted exclusively to business use. Thus, office building condominiums are planned for several major cities. The Massachusetts condominium statute has been amended several times to expressly provide for such projects. Other projects involve property held by various religious bodies or other nonprofit organizations. The developer agrees to develop or redevelop the property and to give the nonprofit organization a specified number of floors in return for its contribution of the land. The balance of the units are reserved by the developer for its own use or sold off to third parties. By means of the condominium concept, the charity is still in a position to retain its tax-exempt status with respect to the area allocated to it, since each condominium unit owner is entitled by statute to have his unit treated as a separate tax lot for assessment purposes.

**CONDOMINIUM FORMAT — ADVANTAGES**

The condominium does offer several advantages to the potential commercial or industrial unit purchaser. In the case of a shopping center, industrial park, or other project with substantial common areas or facilities (such as a large parking field or railroad siding facilities), the condominium arrangement enables smaller companies or entrepreneurs cooperative similar tax deductions as allowed to homeowners — specifically a deduction for each stockholder’s proportionate share of the real estate taxes paid by the corporation. However, section 216 defines a cooperative housing corporation as a corporation in which “80 percent or more of the gross income of which for the taxable year in which the taxes and interest . . . are paid or incurred is derived from tenant-stockholders.” *Id.* at § 216 (b)(1)(B). Consequently, the tenant-stockholder will be disallowed this deduction if more than 20% of the cooperative’s gross income is from outside commercial sources. *See Eckstein v. United States*, 452 F.2d 1036 (Ct. Cl. 1971); *Miller, Tax Problems of the Housing Cooperatives under the 80 Per Cent Income Rule*, 18 PRAC. LAW. 81, 91 (1972).


3 Most state legislation has been based on the Federal Housing Administration model statute which provides in pertinent part:

Each apartment and its percentage of undivided interest in the common areas and facilities shall be deemed to be a parcel and shall be subject to separate assessment and taxation by each assessing unit and special district for all types of taxes authorized by law . . . .

to pool their investments to obtain an equity position that might otherwise be beyond their reach. Again, the business concern purchasing a condominium unit avoids almost all of the drawbacks associated with the leasehold position. The cost of maintaining the property would no longer include an element of landlord profit. Moreover, the danger of nonrenewal of an existing lease, or drastic rent increases upon each periodic renewal, would be eliminated. This, in turn, should enable the business concern to plan its future operations with a greater degree of certainty and to project future costs more accurately. The owner of the commercial unit, being a co-owner of the common areas, as well as sole owner of the unit it has purchased, is in a position to influence the board of managers and to have the property maintained in an adequate, if not opulent, fashion. Where the project originates with one or more of the eventual purchasers, it may be possible to create a manufacturing or commercial center that will house concerns that are engaged in a single industry or interrelated fields. In addition to the obvious public relations value of such a complex, the proximity of firms engaged in a single field or interrelated fields may make possible substantial economies in terms of supplies, deliveries, and inter-company transactions.

Some major cities have enacted a commercial occupancy tax, payable by the lessee, as a revenue raising measure. Acquisition of a commercial condominium unit by a business concern, in lieu of leasing

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4 Recently published figures for the Philadelphia area indicate that office rentals increased an average of 5% per year over the past 40 years. However, the rate of increase over the past decade was found to be 8% per year; and the rate of increase over the past three years 16% per year.

5 Office leasing has become increasingly unstable in recent years, with commercial tenants being subjected to growing uncertainty as to future rent levels and the danger that the lease would not be renewed in order to make the space available to a larger space user or more affluent tenant.

6 As exclusive owner of its unit, the business concern has certainty of tenure which will enable it to make substantial outlays to adapt the unit to its own peculiar needs without fear of having to abandon these improvements upon termination of its lease.

7 From a standpoint of excluding undesirable or competing fellow occupants, a commercial or industrial lessee has no control over the landlord's leasing practices. However, a condominium unit owner, acting through the board of managers, has a degree of control over the entry of new purchasers or unit lessees, as well as remedies that may be invoked against recalcitrant fellow occupants. The importance of this factor, however, is not as great as it would be in the case of a residential condominium.

8 Trade or other associations within an industry may be of great assistance in formulating a group of companies with common interests that would be interested in creating an industrial or commercial condominium.

necessary space, will avoid the commercial occupancy tax burden, since the unit purchaser is an owner and not a mere lessee of the space it occupies. Finally, the condominium arrangement enables the business concern to gain an equity position, which, in turn, enables it to share in the rapidly escalating value of favorably situated real property.

No analysis of the relative advantages of commercial and industrial condominiums over leasing facilities of the same or comparable quality would be complete without a discussion of the ability of the company to expand or contract the space it occupies, or to abandon it altogether if economic or other conditions so dictate. At first blush, the firm that is considering the purchase of a commercial or industrial condominium unit would be "locking itself" into an ownership position, and would not have the flexibility for expansion, contraction or complete relocation that a lessee would have. The lessee, of course, can seek additional space in the same or another building, either as a tenant or sublessee, where expansion is desired, and can contract its operations by subletting part of its space to others. In other instances, it may relocate by subletting or by allowing its lease to expire, or by paying an additional sum to procure an earlier surrender and acceptance of the leasehold space by the landlord. On closer analysis, however, most if not all of these options can be made available to the commercial or industrial condominium unit purchaser.

Lessees of comparable space typically obligate themselves for 10 to 20 years, or obtain options for such periods, in order to warrant expenditures for leasehold improvements and to obviate the need for moving from one place to another with any degree of frequency. Thus, the business concern typically seeks, and in fact enters into, long-term commitments for the space it needs. In this respect, the firm is in no different position than a corresponding condominium unit purchaser.

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10 In New York, qualified unit purchasers may obtain savings up to 60% of their corporate franchise taxes for a period of up to ten years, if the project creates jobs. The franchise tax is now fixed at 9% of pre-tax earnings.

11 Appreciation of well-situated real property that has been substantially improved will result from overall inflation in the economy, as well as the supply and demand factor. The latter is a significant element where commercial properties are concerned, in view of the scarcity of well located properties.

12 Where an office building or other nonresidential condominium project is being built, it is quite common to bring each of the units to a very basic state of completion. The original unit purchaser is then given an allowance towards the cost of outfitting the unit with interior partitions, paneling, carpeting, and other amenities. This same practice is now being employed by developers in constructing high-rise office buildings for use by commercial lessees. Where an existing structure is being converted into an industrial or commercial condominium, it is possible to have the financing cover a substantial portion of the renovations that may be necessary to adapt the property to the needs of the individual unit purchasers.
chaser. The latter can cope with possible complete relocation in the future via the sale of the unit to a third party or to other condominium unit owners that might be interested in expanding, or by leasing the unit to a third party, either on a long term basis or pending its eventual sale. Unlike residential cooperatives, condominium documents do not give the board of managers or fellow unit owners the arbitrary right to reject proposed unit purchasers on a resale or proposed unit lessees. Instead, the board is invariably given a right of first refusal which must be exercised promptly and on the same terms as that received by the firm selling or leasing its unit to a third party. Consequently, no undue delays or unreasonable interference should be experienced by the departing unit owner.

The question of expansion and contraction of one's space requirements is a little more difficult to answer. Nevertheless, while a condominium unit purchaser has no guarantee that suitable additional space will be available nearby or in the building or complex when and as it is needed, neither has the ordinary lessee. Both may acquire more space than they need at the outset, and lease or sublease it to third parties pending their own future expansion. It should be noted, however, that landlords in the commercial field are becoming more interested in the lessee's right to sublet and are beginning to insert restrictive clauses in their leases, or clauses which would give the profit made by the tenant on a sublease rental to the landlord in whole or in part. By contrast, restrictions other than a right of first refusal would be quite rare in a condominium arrangement, since each firm would actually own its unit outright. Expansion can also be provided for in the condominium by inserting a provision in the project's documents to the effect that any unit owner desiring to sell or lease his unit or part thereof must give a right of first refusal to both the condominium's board of managers and, if not exercised by the board, to the owners of other units in the building or complex. This arrangement is merely an adaptation of the familiar "buy and sell" agreement among share-

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13 While the ordinary lessee may feel less "locked in" or committed to his present space (while the condominium unit owner has fee title and a mortgage on his unit), the lessee shares in none of the increment in the property's value over the life of the lease. In marked contrast, the condominium unit owner is free to sell or lease his unit at whatever price the market will bear. This advantage may more than offset the real or imaginary flexibility of the ordinary commercial or industrial tenant.

14 It must also be noted that jurisdictions have held that an unqualified provision against subleasing without the landlord's consent allows the lessor to withhold his consent arbitrarily. See Dress Shirt Sales, Inc. v. Hotel Martinique Associates, 12 N.Y.2d 339, 190 N.E.2d 10, 239 N.Y.S.2d 660 (1963); Richard v. Degen & Brody, Inc., 5 Cal. Rptr. 263 (Dist. Ct. App. 1960).
holders of closely held corporations to fit real estate needs. While a lessee might be able to procure a similar option from his landlord for a consideration, such a situation would not be commonplace. Contraction of one's space requirements also presents no insurmountable problem in the condominium field, since the unit owner may lease his space in whole or in part to others, and may also be able to sell off part of his unit if the underlying project documents so provide.

One further point should be noted. Throughout this discussion, it has been assumed that comparable space or facilities are available to the commercial or industrial lessee in existing properties. However, such may not be the fact. The mutual effort that is part of the condominium format may make it possible to construct improvements (or to adapt existing improvements) to the precise needs of the individual unit purchasers in a prime location, which otherwise would not exist and hence would not be available for rental (or not available at a reasonable rental). Moreover, the prestige of the condominium arrangement may have an intangible public relations or advertising value which, though hard to measure, is quite real.

**Adapting Condominium Documents**

As previously noted, most of the condominium projects marketed in the past decade have been of the residential variety. Accordingly, legal draftsmen fashioning commercial and industrial condominiums are likely to make use of residential condominium documents as a starting point.\(^\text{15}\) While 90 to 95 percent of the provisions found in these documents consist of boiler plate or are mandated by statute, it is essential to make certain modifications and additions to suit the needs of commercial and industrial unit owners. Among the provisions that require special attention are the following:\(^\text{16}\)

1. The rights of the parties in the event of total or partial condemnation, including such topics as the right to contest an award, payment for fixtures, and re-alignment of the condominium in the event of a partial taking.
2. Detail specifications concerning the effect of a casualty loss, interruption of occupancy, casualty and related forms of insurance, and liability insurance protection. While these topics are treated in residential condominium documents, the orientation is different. Thus, for example, business interruption

\(^{15}\) For an illustration of a combined residential-commercial condominium project see IA Rohan & Reskin app. C-5.

\(^{16}\) See id. at app. C-9 for the documentation of a New York industrial condominium.
insurance must be considered and additional casualty insurance costs generated by a particular unit, such as a restaurant, should be allocated to that unit.

(3) Provisions governing the election of the condominium's officers and board of managers must be revamped to take into consideration the fact that in a commercial or industrial project, the office holders may be officers, directors, shareholders, partners, employees, or other persons having a connection with the corporation, partnership, or other business entity that actually owns the various units and may not be unit owners in their own right. For example, provisions must be made for the situation in which an officer of the condominium or a member of its board of managers severs his employment with the firm that owns a unit in the project.

(4) Basic policy decisions must be made at the outset, and perhaps incorporated into the project's declaration and bylaws, concerning such matters as the type of commercial or industrial establishments that will be permitted to acquire a unit in the project, either initially or upon resale. Thus, for example, it may be necessary to decide whether the unit purchasers must be in the same field or an allied field, or conversely, whether the initial unit purchasers will have a monopoly by barring the subsequent purchase of units by their competitors.

(5) While use restrictions may have to be watered down to make units salable to any conceivable commercial or industrial enterprise, it is essential to provide adequate safeguards and remedies for code, fire or other violations by any one unit owner.

(6) While liberal provisions concerning the unit owner's right to sell or lease his unit should be included, it may be worthwhile to provide both the board of managers and the other unit owners with a right of first refusal. This would give each unit owner an opportunity to acquire additional space as the same becomes available, based upon a pre-arranged system of priority. Similarly, the right to subdivide and sell off a portion of one's unit should also be considered.

Statutory Analysis

Most condominium statutes now in effect indicate on their face that they were drafted with residential structures in mind. However, the condominium concept is equally suited to commercial ventures.
Nevertheless, the origin and wording of the various condominium acts is such that one's own enabling statute should be reviewed in depth before embarking upon a nonresidential condominium development. In this connection, the Massachusetts statute was recently amended to specifically authorize nonresidential condominiums. A similar provision should be added to all other condominium statutes. In addition, some attention should be given to the problem areas discussed below which are of vital concern to unit owners in a nonresidential condominium.

**Unintended Governmental Regulation**

In various states the offering of condominium units to the public is subject to approval of the condominium plan and/or other regulation by public authorities. It is clear in some of these states that such regulation is intended by the legislature to apply not just to residential condominiums but commercial condominiums as well. However, in other states, while the applicable statutory regulations seem reasonable in the case of residential offerings, their provisions also technically apply to commercial and industrial condominium offerings and it is questionable whether this result was intended by the legislature.

**Sharing of Common Expenses**

Condominium statutes generally provide that common expenses shall be charged to the unit owners in proportion to their respective interests in the condominium as set forth in the declaration. This

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18 New York requires the filing of a prospectus in a public offering of interests or investments in a cooperative interest in reality. N.Y. Gen. Bus. Law § 352-3(e)(l)(a) (McKinney 1968). Accordingly, the Condominium Act provides that all units under its provisions are for that purpose deemed to be cooperative interests in reality. N.Y. Real Prop. Law § 339-ee (McKinney 1968). In the discretion of the Attorney General, the declaration and bylaws of a nonresidential condominium may be filed in lieu of an offering plan. 13 N.Y.C.R.R. 19.2(b)(2)(xliii) (1964). See also 13 N.Y.C.R.R. 19.2(b)(2)(viii)(a) (1964) which requires that the offering plan must state the intended use of the property, whether commercial, industrial, or residential.


is suitable for residential condominiums, but in a business condominium there may be special facilities serving some unit owners but not others. For example, the store owners may require services not required by upstairs unit owners. It is true that there is nothing to stop the unit owners from agreeing to bear expenses differently from what is called for in the statute, but if they do so, have they then formed a valid condominium; that is to say, if they do not follow the directions specifically set forth in the condominium law, may they then claim the benefits of the condominium law, such as enforcement of statutory liens for common expenses? Massachusetts has recently enacted legislation to resolve this problem.21

Minimum Number of Units

Some states still require that each condominium regime have no less than a specified number of units. Kansas requires five,22 Texas requires four,23 New York requires a "multi-unit" building.24 Some dictionaries define "multi" as meaning more than two, which would mean that each plan must contain at least three units. There would seem to be no public purpose served by requiring a minimum number of units.

Alterations

The Hawaii Act provides that additions to or alterations of a unit require approval of the board of directors and by the unit owners when the plan so provides.25 This may be suitable in a residential condominium, but alterations are frequent in business space and one important inducement to purchasing a commercial or industrial condominium is control over one's property and relief from disputes with landlords over alterations desired by reason of changes in business needs or in connection with a sale of the unit. It would seem that businessmen ought to be free to agree that any of them shall have the free right to make additions and alterations so long as the same do not

21 Mass. Gen. Laws Ann. ch. 183A, § 21(a)(1) (Supp. 1974). The bylaws of the organization of the unit owners may specifically provide that the common expenses can be charged to the unit owners "in proportions other than according to their respective percentages of the undivided interest in the common areas and facilities." The common profits may be similarly distributed. Id.

adversely affect the structure or value of the building.\textsuperscript{26} Also care should be taken to make certain that the unit owner making an addition bears any increased taxes resulting therefrom.

\textit{Lien Priority}

Many condominium statutes provide that common expense liens shall be superior to most other liens, except tax liens and first mortgages.\textsuperscript{27} Other statutes provide a broader exception encompassing all mortgages of record.\textsuperscript{28} The parties involved ought to be free to set whatever priorities they desire. As an example of difficulties which may arise under present statutes, let us take a state such as Hawaii, which provides for superiority of common expense liens over other nongovernmental liens except for any sums unpaid on mortgages of record.\textsuperscript{29} It does not seem fair that the condominium association cannot collect its lien for common expenses because a third mortgagee of a defaulting owner has priority over the condominium association lien. Even in those states which provide priority only for first mortgages,\textsuperscript{30} there is generally no limitation to institutional first mortgages. It is even questionable whether institutional first mortgages should take priority over common expense liens. A common expense lien may be considered akin to a municipal tax, and if that analogy is accepted by the parties concerned, then they may want the common expense liens to take priority even over institutional first mortgages. As mortgagees become more comfortable in the placing of mortgages on condominium units, they will no doubt become more aware of the necessity of seeing to it that common expense liens are paid, even at the expense of subordinating their own first mortgages to such liens. After all, a mortgagee may have more to fear from inability of the condominium association to collect common expense charges from owners of other units, than from the loss of advantage when a common expense charge on its own mortgaged unit takes priority over its mortgage. At any rate, the parties involved should certainly be free to provide whatever sort of priority they want.

\textsuperscript{26} New Jersey recognizes that a material alteration may be established if authorized by the master deed. N.J. STAT. ANN. § 46:8B-3(l) (Supp. 1974). An initially strong bargaining position would not be necessary at the outset of the project's establishment since the master deed may be amended at any time. See \textit{id}. at § 46:8B-3(l).

\textsuperscript{27} See, e.g., MICH. STAT. ANN. § 26.50(16) (Supp. 1974); MINN. STAT. ANN. § 515.23 (Supp. 1974); N.Y. REAL PROP. LAW § 339-z (McKinney 1968).

\textsuperscript{28} See, e.g., HAWAII REV. STAT. § 514-24 (1968); MD. ANN. CODE art. 21, § 11-117 (1973).

\textsuperscript{29} HAWAII REV. STAT. § 514-24 (1968).

\textsuperscript{30} See note 27 \textit{supra}. 
Personal Liability

Some condominium statutes provide for personal liability by each unit owner for payment of his share of common expenses. The parties forming a condominium, however, ought to be free either to provide or not to provide for personal liability as they wish.

Mortgage Recording Taxes

In those states which impose a recording tax on mortgages and other liens, it is important to obtain an exemption from such taxation for common expense liens arising pursuant to condominium statutes. Otherwise the unit owners enforcing a lien against a defaulting owner may find that they have to lay out additional money simply to get their lien enforced.

Specifying Number of Rooms

A common requirement found in condominium statutes is that the master declaration describe the number of rooms in each unit. At the time a condominium plan is filed for an office or other commercial structure, the developer, unlike the builder of a residential structure, does not know how many rooms there will be on any particular floor. One approach is to call each floor of the building one big single room, but this does not seem to squarely fulfill the provisions of the statutes. There would seem to be no policy reason for requiring the declaration to specify the number of rooms in each unit of a commercial structure. Massachusetts has recently enacted legislation which cures this particular problem.

Insurance

Condominium statutes invariably authorize the board of managers to insure the project to full replacement value, at least where the declaration so provides. In addition, the board usually purchases a master

33 New York has exempted condominium liens from the state's mortgage recording tax. N.Y. REAL PROP. LAW § 339-cc(2) (McKinney 1968).
34 See, e.g., GA. CODE ANN. § 85-1610b(c) (Supp. 1973); HAWAII REV. STAT. § 514-11(5) (1968); N.Y. REAL PROP. LAW § 339-n(4) (McKinney 1968).
35 In Massachusetts, the master deed for a nonresidential condominium need not provide for a statement of the number of rooms. MASS. GEN. LAWS ANN. ch. 183A, § 21(b)(1) (Supp. 1974).
36 See MINN. STAT. ANN. § 515.25 (Supp. 1974). Other statutes are ambiguous as to the
liability policy covering the common areas. While these policies may be adequate in residential condominiums, the commercial or industrial needs greater flexibility for several reasons. Very few statutes authorize the allocation of excess insurance premium costs to the unit generating such excess costs as, for example, a restaurant in an office building. Legislation along this line has been adopted in New York\textsuperscript{37} and should be adopted elsewhere. Again, the value of a unit may vary tremendously, depending upon the fixtures and other permanent improvements installed therein. This is usually not the case in residential condominiums. Accordingly, some thought should be given to a statutory amendment which would give greater flexibility in the insurance area to commercial and industrial condominiums. From the insurance industry's side, greater effort should be made to develop integrated master and unit owner policies, in order to reduce the possibility of multiple carriers covering the same risk with attendant waste of premiums and loss settlement difficulties.

\textit{Clarification of the Right to Sue; Contributory Negligence and Liability Carrier Responsibility}

Since each condominium unit owner is a tenant in common of the common elements, and may also be viewed as the employer of condominium personnel, a substantial question exists as to whether a unit owner may sue the group in the event he is injured as a result of the condition of the common elements, or as a result of the act or omission of condominium employees. As a co-owner himself, the would-be plaintiff may be faced with the doctrine of contributory negligence. If that hurdle is surmounted, the plaintiff may still be barred from recovering under the group's master liability policy on the theory that an insured cannot recover from his own liability carrier. One recent appellate court decision in California sustained the unit owner's right to sue,\textsuperscript{38} but it is questionable whether other courts will follow this

\textsuperscript{37} N.Y. \textit{Real Prop. Law} § 339-bb (McKinney 1968).

\textsuperscript{38} White v. Cox, 17 Cal. App. 3d 824, 95 Cal. Rptr. 259 (Dist. Ct. App. 1971). The unit owner sued the association for injuries sustained when he fell over a sprinkler negligently maintained by the association in the common area. In reversing the lower court's grant of the defendant's demurrer, the court of appeals held that the association was a separate legal entity from the condominium unit owner. The court specifically drew attention to the fact that the plaintiff had no direct control over the association's operations. \textit{Id.} at 830, 95 Cal. Rptr. at 262-63.

Ohio recognizes that the association may be sued as a separate legal entity in actions relating to the common area. \textit{Ohio Rev. Code Ann.} § 5311.20 (1971). However, the statute does not consider whether a unit owner may be a plaintiff in any such suit.
precedent. Some attention should be given to the foregoing problems, in view of the likelihood of personal injury in a commercial or industrial setting, and the unit owner's lack of any real day-to-day control over the common elements. At the same time, it would appear appropriate to consider exoneration of individual unit owners from personal liability in this context. Revision of the condominium statutes to permit incorporation of the common elements has been suggested as one method to accomplish this result.

Substantial Destruction of the Premises

Most statutory provisions governing substantial destruction of the condominium project are both vague and cumbersome. The typical statute demands a rather large percentage vote to authorize reconstruction after a major casualty loss, and lacks precision as to the time element involved. Again, if restoration is frustrated, some unit owners may receive a windfall. Where the project is not to be repaired, most statutes stipulate that the insurance proceeds and amount realized on sale of the damaged project are to be distributed according to the undivided fractional interest of each unit owner as set forth in the declaration. This could work a hardship upon the unit owner who has expended a large sum to renovate his space or who otherwise generates a larger insurance recovery than normally would be obtained. In short, much greater flexibility should be afforded by the condominium statutes to the draftsmen of commercial and industrial condominium documents, to enable them to hand tailor provisions relating to total and partial destruction of the premises.

Eminent Domain Provisions

Most condominium statutes are totally silent on the subject of eminent domain, while still others contain unworkable provisions. While this situation may not be too problematical in a residential setting as, for example, a high rise apartment project, it may prove disastrous in a commercial or industrial condominium. Thus, in the absence of an eminent domain provision in the statute, courts are likely to treat a condemnation case as being governed by the statutory provi-
sions that control destruction of the condominium. The latter statutory sections are vague and arbitrary and were never intended to cover eminent domain matters. Among the vital topics left open are: standing of individual unit owners to contest an award through counsel of their own choosing; the unit owner's right to claim consequential damages when less than all of his unit is taken; the unit owner's right to be paid for his fixtures; loss of good will and relocation allowances; and contraction of the condominium to reflect a partial taking, including realignment of the undivided percentage interest of each remaining unit owner to reflect the contraction.42

The Right to Subdivide, Combine or Alter Units

It may well be essential for commercial or industrial condominium unit owners to subdivide their units within certain prescribed limits, to expand them or otherwise realign them. Most of the present statutes do not contain the necessary mechanics for accomplishing such a change.43

Easements

A further omission in most condominium statutes is the failure of the legislature to bestow authority upon the condominium to grant or relocate easements. Such authority will prove an absolute necessity in a nonresidential project of any size or complexity.

Phased Projects

Still another problem is the failure of most existing condominium statutes to make adequate provisions for phased projects of any kind.44 In certain commercial or industrial condominium projects, such as shopping centers, it may be essential to build in sections or phases over a period of several years.

Leasehold Condominiums

While residential condominiums built on a leasehold may prove a trap for the unwary purchaser, it is not uncommon for commercial or industrial projects to be built upon a leasehold. Such leasehold projects are likely to increase in view of the growing tendency of municipalities

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42 For an example of a statute that provides the needed flexibility in this vital area see N.Y. REAL PROP. LAW § 339-l(2) (McKinney 1968).
43 New Jersey, on the other hand, provides the procedures for realigning units. See note 26 supra.
44 Rare exceptions are Md. CODE ANN. art. 21, § 11-117 (Supp. 1974); ORE. REV. STAT. § 91.530 (1971); VA. CODE ANN. § 55-79.39-79.72 (Supp. 1974).
to retain title to urban renewal sites, while leasing them to developers on a long-term basis. Faced with this fact of life, it would seem appropriate to amend existing legislation to permit commercial and industrial condominiums on a leasehold or sublease.45

Reduction of Percentage Vote Requirements

Most condominium statutes contain extremely high percentage requirements for passing certain motions, such as a vote to amend the bylaws or repair the project after a casualty loss.46 These percentages are so high that they have caused difficulty in the residential field. They will prove even more mischievous in a business setting and should be reduced.

Arbitration

Business arrangements are often facilitated by an arbitration clause set forth in the basic understanding reached by the parties. Some thought should be given to inclusion of a statutory provision which would authorize draftsmen of commercial and industrial condominium projects to include an arbitration provision in their documentation. While such a clause would no doubt be binding upon the original unit buyers without any supporting legislation, it would seem preferable to have a statutory base for the arbitration provision and thereby resolve all doubts as to its binding nature as to purchasers of units on resale.47

Tax Planning: Conversions

The principal reason impelling an owner of an office building or commercial property to convert it to a condominium is usually the desire to maximize his profit upon liquidation of his investment through sale of the condominium units both to the present tenants, who are often the most likely buyers in light of their investment in improvements and desire to remain in the building, or to nontenant purchasers who would prefer to purchase rather than rent space.

By dividing the property into salable units, the owner hopes to sell his property at a higher price than he would obtain by selling it to one purchaser. In addition, the condominium might be a desirable

45 The New York Legislature has recently provided for nonresidential leasehold condominiums. N.Y. Sess. Laws [1974], ch. 1056, § 1 (McKinney).
46 In Maryland, unanimous agreement by the unit owners is required to authorize reconstruction when two-thirds of the project has been destroyed. Md. Ann. Code art. 21, § 11-120 (1973). See note 39 and accompanying text supra.
47 Massachusetts permits the condominium bylaws to include a provision for arbitration of disputes concerning the condominium's administration. Mass. Gen. Laws Ann. ch. 183A, § 12(b) (Supp. 1974).
form of holding nonresidential property in order to facilitate partial dispositions of the property. For instance, if an office building were a condominium, the owner might be able to sell units to tenants at strategic times, e.g., when a major tenant's lease expires or a tenant is about to make substantial improvements. The owner who converts his property to condominium status would also be able to grant options to purchase units to tenants in connection with lease renewals.

Some owners may seek other economic and tax benefits from a conversion to condominium status. Thus, an owner may make a tax deductible contribution of units to a charity or to its profit-sharing or pension trust, possibly with a leaseback of the space. For example, the First National Bank of Seattle recently converted its home office building into a condominium, and then contributed three units, valued at $2.5 million, to its employees' retirement trust fund as its contribution for the year. The bank then leased back the units. The contribution of a condominium unit by an employer to its pension trust gives rise to a current deduction based on the fair market value of the unit even if the unit is leased back to the employer. If the fair market value of the unit exceeds the owner's basis, the owner will realize a long-term capital gain, or, to the extent of depreciation subject to recapture, ordinary income.

If a unit is a capital asset or a 1231 asset held for more than six months, no gain will be realized on its transfer to a charity. However, under section 170(e), to the extent that gain upon the sale of the unit would not be long-term capital gain, e.g., by reason of depreciation recapture, the amount of the deduction will be reduced. It might be contended by the IRS that if a building has been converted to condominium status with a view to immediate sale of all of the units, the units at that time represent "ordinary income" assets and, therefore, by reason of section 170(e)(1), a contribution of one of the units will not give rise to a charitable deduction, except to the extent of the donor's basis in the unit.

A variety of other planning possibilities are afforded the owners of commercial property by conversion to condominium status. For in-

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51 INT. REV. CODE of 1954, § 1250.
52 Id. § 170(e).
53 Id. § 170(e)(1)(A).
stance, if an owner occupies a substantial portion of the building and wants to realize upon the value of, or diversify a part of, his investment, he might, after conversion to condominium status, sell the units not occupied by him or exchange them for other real property in a tax-free exchange under section 1031 and retain the unit he occupies.

Capital Gains or Ordinary Income

The sale of a building by conversion to a condominium and disposition of units normally involves multiple sales to multiple purchasers, as distinguished from a single sale of the building. Thus, even though the seller has owned the building for many years and it qualifies as real property used in a trade or business, gain on the sale of which is normally taxed at capital gains rates under section 1231, the IRS will probably contend that, in light of the multiple sales, the seller is a "dealer" and therefore recognizes ordinary income. Various factors must be considered to determine whether the Service will be successful in arguing that the seller is a "dealer"; more precisely, that the seller has entered the trade or business of selling units and that the condominium units are "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" under section 1231(b)(1)(B).

There do not appear to be any reported cases involving the tax consequences of sale of a building through conversion to condominium status and multiple sale of condominium units. There are, however, a number of cases on whether a taxpayer realizes capital gain rather than ordinary income with respect to land which he has owned for a substantial period of time and which he disposes of by subdivision and sale of the land in parcels.

A substantial number of courts have adopted the rule, called the "liquidation of investment" rule, that if a taxpayer finds that the only reasonable and advantageous way to liquidate his investment in land...
is to subdivide the land, his gain will be taxed as capital gains notwithstanding that he has engaged in multiple sales of the parcels. The owner of commercial property, who finds that the sale of his property through subdivision into condominium units is the only advantageous way to sell the property, should at least in certain circumstances be able to rely on the liquidation-of-investment rationale developed in land subdivision cases in claiming capital gains treatment on the sale of the condominium units.

A key factor in the liquidation-of-investment cases is whether the taxpayer, when he began to subdivide his property, intended to enter the business of selling subdivided lots or merely wanted to liquidate his realty position with as much gain as possible. Thus, if the taxpayer's principal business is not real estate, but he has an independent vocation, the courts will apparently be more inclined to find that he has not entered into a side business of selling parcels of real property. On the other hand, if the taxpayer's original purpose in acquiring realty was to subdivide it, it will be difficult for him to argue that he is merely liquidating an investment asset.

By analogy, if a building has been owned only a short time before it is converted to a condominium by the taxpayer, it will be difficult for him to argue that his original intent was to hold the property for investment. The liquidation-of-investment cases also stress the following factors which, if present, would seem to support the argument that capital gains treatment is appropriate upon sale of units of a building after its conversion to a condominium:

55 See, e.g., Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967); Municipal Bond Corp. v. Commissioner, 382 F.2d 184 (8th Cir. 1967); Municipal Bond Corp. v. Commissioner, 341 F.2d 683 (8th Cir. 1965); Gudgel v. Commissioner, 273 F.2d 206 (6th Cir. 1959); Curtis Co. v. Commissioner, 232 F.2d 167 (5d Cir. 1956); Smith v. Dunn, 224 F.2d 353 (5th Cir. 1955); Ross v. Commissioner, 227 F.2d 265 (5th Cir. 1955); Camp v. Murray, 226 F.2d 931 (4th Cir. 1955); Dillon v. Commissioner, 213 F.2d 218 (8th Cir. 1955); Lazarus v. United States, 172 F. Supp. 421 ( Ct. Cl. 1959); Gordon v. United States, 159 F. Supp. 360 ( Ct. Cl. 1958); Randolph D. Rouse, 30 T.C. 70 (1962) (sale of houses held originally for rental).


59 Cf. Alexander L. Baris, 34 P-H Tax Ct. Mem. 1038 (1965), wherein a partnership purchased an apartment building in New York City and sold it to a cooperative 16 months later. The Tax Court, in holding that the sale gave rise to ordinary income, based its decision on the fact that the partnership had not established that it intended at any time to hold the property for rental or investment purposes.
(1) The owner demonstrates that his efforts to sell the building to a single purchaser have been unsuccessful.60

(2) The owner hires an independent agent to handle the sales and advertising, and does not himself engage in selling activity. In addition, the more minimal the selling activity by the owner's agents, the more likely capital gains treatments will be allowed.61

(3) A request has been initiated by one or more of the tenants that the owner sell the units.62

(4) The owner refrains, to the extent possible, from making extensive improvements in order to make the units more salable.63

(5) The owner has held the building for a relatively long period of time prior to the sale of the condominium units.64

(6) The owner invests the proceeds of the sale in nonrealty investments or a separate business.65

The decision of the Supreme Court in Malat v. Riddell,66 that the term "primarily" in the phrase "primarily for sale to customers in the ordinary course of business" means "of first importance" or "principally," rather than just "substantial," did not deal directly with the liquidation-of-investment rationale. However, in explaining its interpretation of the purpose of the statutory provision regarding "dealers," the Court indicated that the purpose was to differentiate between profits "arising from the everyday operation of a business," which are taxed as ordinary income,67 and "the realization of appreciation in value accrued over a substantial period of time," which is taxed at capital gains rates.68 The Court's view appears to have provided the impetus for subsequent decisions which have approved of the liquidation-of-investment rationale.69

The clearest post-Malat approval of the rationale is found in the

60 See Goldberg v. Commissioner, 223 F.2d 709, 712 (5th Cir. 1955).
61 See Camp v. Murray, 226 F.2d 991 (4th Cir. 1955); Dunlap v. Oldham Lumber Co., 178 F.2d 781 (5th Cir. 1950).
62 See Municipal Bond Corp. v. Commissioner, 382 F.2d 184, 189 (8th Cir. 1967) (option to buy inserted in lease at tenant's insistence); Municipal Bond Corp. v. Commissioner, 341 F.2d 683, 690 (8th Cir. 1965) (subdivided properties sold at purchaser's request); Camp v. Murray, 226 F.2d 991 (4th Cir. 1955) (owner requested to devote farm to residential purposes).
63 See Ross v. Commissioner, 227 F.2d 265 (5th Cir. 1955).
64 See Municipal Bond Corp. v. Commissioner, 382 F.2d 184 (8th Cir. 1967).
67 Id. at 572, citing Corn Prods. v. Commissioner, 350 U.S. 46, 52 (1955).
69 See, e.g., Heller Trust v. Commissioner, 382 F.2d 675 (9th Cir. 1967); Scheuer v. Commissioner, 371 F.2d 996 (7th Cir. 1967); cf. Michael L. Rockwell, 41 P-H Tax Ct. Mem. 621 (1972).
Ninth Circuit’s 1967 decision in *Heller Trust v. Commissioner,*\(^70\) in which the court stated:

> Where the facts clearly demonstrate that a taxpayer held certain property as an investment, and further show that this purpose continued until shortly before the time of a sale, and that the sale is prompted by a liquidation intent, the taxpayer should not lose the benefits provided for by the capital gain provisions.\(^71\)

Notwithstanding that the liquidation-of-investment rationale would appear to be applicable to the conversion of commercial property to a condominium with the view to sale of units when the property has been held “primarily” for rental prior to its sale, it can be expected that the Internal Revenue Service will take the position that sale of the units gives rise to ordinary income. Nevertheless, if the property has been held for rental for a substantial period of time, the liquidation rationale would appear to be the best argument supporting capital gains treatment. If the Service is successful in arguing that conversion to condominium and sale of units represents a fundamental change in the taxpayer’s “primary” purpose for holding the property to that of selling the units, perhaps the taxpayer can contend at least that only the income attributable to the excess value realized by the condominium method of sale is taxable as ordinary income; any appreciation in value during the time the property was held “primarily” for rental would then be taxed at capital gains rates.\(^72\)

**Sale to Middle Man**

The owner may attempt to structure a transaction in which a syndicate or corporation not controlled by him purchases the building from him with a view to making a profit by converting it to a condominium. Typically, the seller will take back a substantial mortgage, often on a nonrecourse basis, which defers the amount which must be paid by the purchaser until it is able to sell the units, and reduces the risk of the purchaser. A key issue in this type of “flip” transaction is whether the purchaser and seller are really joint venturers in the conversion project, in which case the single “sale” by the owner will be

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\(^{70}\) 382 F.2d 675 (9th Cir. 1967).

\(^{71}\) Id. at 680. In *Heller Trust*, six corporations in which the taxpayer owned an interest built and rented 186 duplex houses. Since the rental operation was failing, the corporations were liquidated, taxpayer and the other stockholders receiving the duplexes. The stockholders sold 169 of the duplexes in a three-year period. The Ninth Circuit held that, since the duplexes were acquired and held prior to their sale primarily for rental purposes and not for sale, the taxpayer was entitled to capital gains treatment. *See also* Peter R. Shibley, 40 P-H Tax Ct. Mem. 623 (1971).

disregarded by the Service and capital gain treatment will not be achieved.

In arranging this type of transaction, it is important that the purchaser have some significant economic risk in the transaction such as a substantial down payment and that the owner-seller not receive merely a share of "profit" from the resale of the units, e.g., his sale price should be fixed and should contemplate a substantial profit for the purchaser entity.\(^7\) Especially where the seller is entitled to a share of profit, if the seller is considered to have retained any involvement in the purchaser's operation, a joint venture between them may be deemed to exist.\(^4\) Alternatively, if the seller retains any control over the sales activities of the purchaser, the Service may impute the sales activities of the purchaser to the seller.\(^5\) Middleman transactions will have a much greater chance of succeeding if the seller has no or only a very small equity interest in the purchasing entity.

Sale of a building to a corporation more than 80 percent of the value of which is owned by the taxpayer would subject the gain to ordinary income treatment under section 1239. Since section 1239 applies if the property in the hands of the transferee is depreciable, it might be contended that because the purchasing corporation intended to sell the property rather than hold it for rental, it is not depreciable property in its hands and the section is not applicable.

Partial Dispositions

As suggested above, an owner may find it advantageous to convert an office building or industrial property into a condominium, with a view to selling off some of the units on a piecemeal basis. Although sale of the units over a lengthy period of time would appear to be inconsistent with the liquidation-of-investment rationale, the courts appear to treat sales of subdivided property over an extended period as qualifying for capital gains treatment, presumably on the theory that each parcel retains its character as an individual investment.\(^6\)

\(^7\) See, e.g., Wyche v. Commissioner, No. 490-71 (Cl. Ct., Feb. 26, 1974), reported in 3 CCH 1974 Stand. Fed. Tax Rep. ¶ 7911; Nadalin v. United States, 364 F.2d 431 (Cl. Ct. 1966). In Wyche, the partnership sold land to a development company in which two partners were employees. The purchase price was set at 90% of the receipts from the eventual sales of subdivisions. The partnership was held to have realized ordinary income from a "joint business endeavor" with the development company.


\(^5\) See Bauschard v. Commissioner, 279 F.2d 115 (6th Cir. 1960); Achong v. Commissioner, 246 F.2d 445 (9th Cir. 1957); cf. Voss v. United States, 329 F.2d 164 (7th Cir. 1964).

\(^6\) See, e.g., Gordon v. United States, 159 F. Supp. 360 (Cl. Ct. 1958) (sale of 112 lots over 15 years).
The sale of a condominium unit to a tenant exercising an option to purchase the unit when his lease expires should have a good chance of qualifying for capital gains treatment, both because it involves an isolated sale of property held "primarily" for rental rather than sale, and because the tenant rather than the owner initiates the sale through exercise of his option. Similarly, if the owner sells off a substantial portion of the units but retains one or more units for which a valuable lease exists or which he himself occupies, a later sale of the retained unit also should have a good chance of qualifying for capital gains treatment, even if the initial sales do not so qualify.

TAX PLANNING: NEW CONDOMINIUMS

In the normal situation in which a developer buys the land, constructs a building thereon and sells the condominium units, his profit will be taxed as ordinary income since he almost certainly will be a "dealer" with respect to the units. In this situation, the developer's tax objectives usually are to defer the recognition of income as long as possible, and to minimize taxation of profit realized by him. In addition, the availability of construction losses which can be deducted against other income usually is advantageous to the developer. In some circumstances, discussed below, it may be possible for the developer to obtain part, if not all, of the profit realized upon the sale of the condominium units as a capital gain or as earned income taxable at a maximum federal tax rate of 50 percent.

Choice of Entity — Nontax Factors

The developer's potential liability to purchasers of units may militate against use of an individual proprietorship or partnership, and in favor of use of a regular corporation or Subchapter S corporation. Use of a limited partnership will provide protection from liability beyond the limited partner's investments. If the developer sets up a corporation to be the general partner of the limited partnership, it will usually provide the developer with protection from liability.

77 See, e.g., Municipal Bond Corp. v. Commissioner, 382 F.2d 184 (8th Cir. 1965).
80 § 1371.
81 If the sole general partner is a corporation, of course, careful consideration will have to be given to certain net worth, stock ownership and other criteria. Safe harbor rules have been established by the Service in Rev. Proc. 72-13, 1972-1 Cum. Bull. 735, to determine whether a limited partnership having a sole corporate general partner will qualify for taxation as a partnership. See generally Shapiro, Tax Planning for Equity Financing by Real Estate Developers, 50 Taxes 550, 537-38 (1972). See also Rev. Proc. 74-17, 1974 Int. Rev. Bull. No. 22, at 17.
Using Construction Losses

The conduit feature of a partnership and Subchapter S corporation make them well suited for condominium development, where construction losses, principally from property taxes, interest, deductible loan fees and, in some cases, sales taxes, can be utilized to offset other income of the developer, or at least to create a net operating loss which will offset the first profits earned upon a sale of the condominium units.\textsuperscript{82} One advantage of a partnership over a Subchapter S corporation is that the partners can take deductions even though they exceed their investment, because, under section 752(a), their basis in the partnership includes their share of the partnership's liabilities. If a limited partnership is used, the limited partners' basis includes their share of partnership liabilities as to which no partner is personally liable.\textsuperscript{83} On the other hand, a stockholder of a Subchapter S corporation cannot deduct losses in excess of his basis which, under section 1374(c)(2), is limited to his adjusted basis in his stock and any indebtedness of the corporation to him, and is not increased by other liabilities of the Subchapter S corporation. Thus, if most of the funds for construction are raised through outside financing, rather than from capital contributions or loans from the developer, current construction losses in excess of the developer's investment may be permanently lost if a Subchapter S corporation is used since the unused losses of a Subchapter S corporation cannot be carried over to another year of the corporation, and cannot be carried over by the shareholders to another taxable year.\textsuperscript{84} By contrast, if a limited partnership is used and losses allocated to the limited partners cannot be deducted by them because the losses exceed their tax bases, \textit{e.g.}, because the partnership cannot obtain nonrecourse financing, the losses can be carried over and deducted by the limited partners to the extent of their tax basis at the end of the next succeeding fiscal years.\textsuperscript{85}

\textit{Taxation of Profits}

The principal advantage of a corporation is that the federal corporate tax rate is only 22 percent on the first $25,000 of annual net income and 48 percent on the balance.\textsuperscript{86} This lower tax rate can be advantageous when the corporation is to be a continuing development

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\textsuperscript{82} \textit{Int. Rev. Code} of 1954, § 1374.
\textsuperscript{83} \textit{Treas. Reg.} § 1.752-1(e) (1956).
\textsuperscript{85} See \textit{Int. Rev. Code} of 1954, § 704(d).
\textsuperscript{86} \textit{Id.} § 11.
\end{flushright}
company and its earnings will be used for payment of debt or reinvestment. One major problem with use of a regular corporation is the potential double taxation if the corporation's earnings are later distributed as dividends or in liquidation. 87

By contrast, a Subchapter S corporation and a partnership, as conduits, allow a passthrough of the profit so that it is taxed only once. 88 If income from sale of condominium units is taxed to a partner or stockholder directly, he may be able to shelter it with deductions from other projects. Income from development and sale of a condominium unit is not rental income, and should therefore not terminate a Subchapter S election. However, if a Subchapter S corporation is used and, pending the sale of condominium units, the corporation rents the unsold units, it must use care to avoid a termination of the election which would result if it received more than 20 percent of its gross income in the form of rents. 89 It may be advantageous to use a Sub S election during the construction period, and revoke the election when profits begin to be realized.

Attention will have to be paid by condominium developers to the impact of tax reform proposals which are presently under consideration. A typical pattern followed by developers has been to use a separate Sub S corporation or partnership for development of each condominium project, and to take maximum current deductions for construction expenses. This, of course, has meant that as profits begin to be earned on a particular project, they may be bunched together in a few years. However, a developer would then seek to shelter the profits by offsetting them with construction losses incurred in other projects timed to commence as the profits are earned; in this way, all or a significant portion of the taxation of the developer's profits potentially could be deferred indefinitely as long as he continued to construct new projects.

The April 30, 1973, tax reform proposals by the Administration, which the Administration has indicated it may advocate again this year, would eliminate this deferral technique. Under the Administration's Limitation on Artificial Loss ("LAL") proposal, construction losses such as interest, taxes and other deductible "preopening" costs would be deductible only against "related" income — which in the case of commercial property would include only income from the particular property or building to which the deductions are attributable. In short, under LAL, losses from the development of one commercial project,

87 Id. §§ 11, 301.
88 Id. §§ 701, 1372.
89 See id. § 1372(e)(5).
such as a nonresidential condominium, would not be deductible against profits from another commercial development. Although the House Ways and Means Committee has indicated an intention to propose a modified LAL rule, it may not be as onerous as the Administration's LAL proposal because apparently "related" income would be defined broadly to include all income from real estate.

Reasonable salaries paid by a corporation, whether a regular or Subchapter S corporation, will qualify as earned income taxable at a maximum rate of 50 percent. Thus, salaries might be paid to principals of the developer who can perform construction supervisory services, sales services, etc. To the extent such salaries are received for services actually performed, they should qualify as "earned income."

**Realizing Capital Gains**

Often a developer will acquire land which he later decides is ripe for development as a condominium. As indicated above, if he merely constructs the condominium on the land, even though it has been held for a long time by him, his profits attributable to the appreciation in the land will be taxable as ordinary income. However, the developer might sell the land to a corporation or partnership which is formed to purchase the property and construct a condominium thereon. Typically, the developer can structure the sale as an installment sale, thereby deferring tax, by taking back a note having a principal amount equal to the assumed value of the land, payments on which will be due as the condominium units are sold by the purchaser of the land. If the land has been held for investment, the developer may be able to obtain capital gains treatment when the note is paid off. Great care must be taken by the developer to set a reasonable fair price for the land and, if possible, to avoid selling the land to a corporation substantially owned or controlled by him.

Although the Code denies capital gains treatment for sales of depreciable property by an individual to a corporation more than 80 percent controlled by him, capital gains treatment for profits from the sale of land to a controlled corporation has sometimes been upheld by the courts. However, there is a substantial risk that the Service will

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90 The Administration's LAL proposal does not purport to apply to regular corporations. Thus, if the proposal were adopted, developers might have to consider using separate regular corporations which join together in a consolidated return, rather than Subchapter S corporations, in an effort to use construction losses to offset income from other projects.

91 **Int. Rev. Code** of 1954, § 1239. See also **id.** § 707(b) (sales between partner and more than 80% owned partnership).

contend that he has merely made a contribution to capital if the corporation is thinly capitalized and is owned by the developer, his relatives or others under his control.

If the Service's argument is successful, since the corporation will have a carryover basis for the land, its taxable profits will be increased, and its payments of the note held by the developer will be taxable as a dividend to him. This double taxation result should be minimized if the developer corporation is a Subchapter S corporation since the payment of the note should represent nontaxable distributions of previously taxed profits. Sale of land to a partnership formed to develop a condominium in exchange for the partnership's nonrecourse note, payable when the condominium units sales are completed, also may be characterized by the Service as a contribution to the capital of the partnership by the seller. The result would be a larger profit to the partnership, and the seller as a partner would be taxed at ordinary income rates on his share.

Where the owner wishes to retain a substantial or controlling interest in the purchaser, an appraisal should be obtained justifying the purchase price as fair, for even if the purchasing corporation is not "thin" and the transaction is a valid sale, if the price is in excess of fair market value at the time of sale, the excess price will be taxed as a dividend to the seller, and the purchasing corporation's basis will be limited to the fair market value of the property. The landowner should be careful not to take steps, such as applying for a zoning variance, which would indicate personal efforts or an intention to construct a condominium on the land, and would lead the Service to argue that the landowner's actions prevent him from qualifying for capital gains treatment. Even when the owner has not taken any such action, the trend of recent cases is to disallow capital gains if the property is sold to a corporation controlled by him. To be safe, the owner of land should sell the land to a corporation or partnership which is substan-

93 See Burr Oaks Corp. v. Commissioner, 365 F.2d 24 (7th Cir. 1966), cert. denied, 385 U.S. 1007 (1967); Aqualane Shores, Inc., v. Commissioner, 269 F.2d 116 (5th Cir. 1959).
96 See, e.g., Brown v. Commissioner, 448 F.2d 514 (10th Cir. 1971); Browne v. United States, 356 F.2d 546 (Ct. Cl. 1966); Tibbals v. United States, 362 F.2d 266 (Ct. Cl. 1966).
97 See Robert A. Boyer, 58 T.C. 316 (1972).
tially independent, and which makes a significant down payment for the land.

In certain circumstances, the owner of land may forego getting the maximum profit for sale of land, letting an independent sponsor group reap this profit. In return, he might obtain contracts for the performance of construction work, brokerage services, etc., which may result in income taxed partially or wholly as earned income or on a deferred basis. In this type of planning where various related entities often are used, there is always a risk that the transactions will be subject to reallocation under section 482.

Sale of Land Subject to Lease

In states which allow leasehold condominiums, the landowner might retain the land for future sale by setting up a long-term ground lease and selling only the improvements. The IRS has ruled that, where the lease term exceeds the useful life of the building, none of the proceeds from the sale of the individual leasehold condominium units will be treated as advance rent, which might be fully taxable without deduction for the seller's basis in the improvements, but they will be taxed as part of the proceeds from the sale of the units.

If the owner of the land sells the land (subject to the leases) to a third party after the building has been completed and the units are sold, such a sale should result in a capital gain. Consideration should be given, in establishing the land lease rental, to whether the rental exceeds a fair rental on the land as if it were unimproved. If the lease rental is based on the value of the land as improved, the owner may have to allocate part of his basis in the building to the retained interest in the land, thereby increasing his ordinary income on sale of the units.

Under certain circumstances, this threat of a reduction in basis may not outweigh the apparent advantage to the owner of being able to sell the land at capital gains rates for a large price by reason of the inflated future rental. However, in a number of recent cases in Florida

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101 See Welsh Homes, Inc. v. Commissioner, 279 F.2d 391 (4th Cir. 1955).
involving residential leasehold condominiums in which an inflated long-term land lease rental was retained by the seller, the Service has apparently argued that the seller-landlord must include as sales proceeds, at ordinary income rates, the present value of the right to receive that part of the rental income in excess of what the Service believes is a fair rental. \(^{102}\) This same contention could be made in the case of a nonresidential leasehold condominium.

Liquidation or Sale of Developer Corporation

One technique which may afford the developer the opportunity for capital gains is to use a corporation to develop the condominium. After a substantial number of units have been sold and a substantial part of the corporation's income has been realized, the corporation is liquidated. The fair market value of the unsold units, which are distributed in liquidation to the stockholders, is taxed to the stockholders at capital gains rates under sections 331(a)(1) and 1001(b). When the stockholders later sell the units, there will be no additional income except to the extent the units have appreciated over their value at the time of the liquidation, since the stockholders' basis in the units will be fair market value at distribution.

The above technique works only if the liquidated corporation is not a "collapsible corporation." One of the rules under section 341(b) is that a corporation will not be deemed "collapsible" if it has realized a "substantial" part of the taxable income to be derived from its manufacturing or construction operations. In a revenue ruling,\(^{103}\) the IRS acquiesced in Commissioner v. Kelley\(^ {104}\) that "substantial" realization of income means the realization of \(\frac{3}{4}\) percent of the taxable income to be derived from the venture. Thus, it would appear that if the liquidation does not take place until after one-third of the corporation's expected taxable income is "realized," the gain of the stockholders will not be taxable as ordinary income on the basis that the corporation is "collapsible."

Care must be taken in using this "collapsible" technique that the

\(^{102}\) The Service apparently is taking the position that a "reasonable" annual land rental for a condominium should be approximately 8% of the seller's land cost. Thus, if the land cost is $500,000, the total amount of land rental, according to the Service, should be $40,000. If the annual land rental were, say, $100,000, the Service might contend that the seller annually will receive $60,000 of "unreasonably" high rent. The Service, apparently, might then multiply the $60,000 by ten and contend that the present value of the excess rent is $600,000! For a discussion of the current status of this issue and other issues involving "residential condominiums," see Emanuel, Condominium Developers and the Internal Revenue Service—The Florida Story, 2 REAL ESTATE L.J. 760 (1974).

\(^{103}\) Rev. Rul. 72-48, 1972-1 CUM. BULL. 102.

\(^{104}\) 293 F.2d 904 (5th Cir. 1961).
Service cannot argue that, despite the liquidation and sale of distributed units by the stockholders, the sales actually were effected by, and should be taxable to, the corporation under Commissioner v. Court Holding Co.,\textsuperscript{105} which holds that income must be imputed to a liquidated corporation if it actually commenced the negotiations for the sale of property distributed to the stockholders and purportedly sold by them.\textsuperscript{106} Various other practical problems are presented by this technique, which may not be especially attractive to a developer who, having used a corporation for the condominium development, does not wish to incur any personal liability to the purchasers of the distributed units. Moreover, the developer must be prepared to pay capital gains tax on the difference between the value of the unsold units and his basis at a time when he may be unable or unwilling to sell the distributed units.\textsuperscript{107} If the corporation has realized substantial losses by reason of construction write-offs, the time before which it will realize 33 1/3 percent of its taxable income will be lengthened.\textsuperscript{108}

Instead of liquidating the developer corporation, an attempt might be made to sell its stock to a third party after the corporation has realized a "substantial" part of its taxable income. If the corporation is "collapsible" because there had not been a "substantial" realization of income, other methods, \textit{e.g.}, a 341(f) consent,\textsuperscript{109} may be used to achieve capital gains upon the sale of the stock. Furthermore, an attempt might be made at some point to exchange the stock of the developer corporation in a tax-free reorganization for shares of a public corporation interested in continuing the business of the developer.\textsuperscript{110}

\textsuperscript{105} 324 U.S. 331 (1945).

\textsuperscript{106} In Rev. Rul. 72-48, 1972-1 Cum. Bull. 102, the Service stated that, even though under \textit{Kelley} a corporation is not "collapsible," the Service "is not precluded from applying other provisions of the Code to tax the gain as ordinary income."

\textsuperscript{107} The "collapsible" technique requires the developer to estimate the percentage of taxable—not gross—income derived prior to the liquidation of the total taxable income to be earned from the property.

\textsuperscript{108} See Arthur Pomponio, 33 T.C. 1072 (1960), aff'd, 288 F.2d 827 (4th Cir. 1961).


\textsuperscript{110} In Rev. Rul. 73-378, 1973 INT. REV. BULL. No. 38, at 6, the Service ruled that even if a corporation is "collapsible," its stock can be exchanged tax-free in a transaction qualifying as a reorganization, and a subsequent sale of the stock of the noncollapsible corporation, if not "intended" at the time of the reorganization, will qualify for capital gains treatment. If the acquiring corporation proceeds to sell all of the condominium units, however, the Service might argue that the continuity-of-business-enterprise requirement of a reorganization is not met since the acquired corporation is in reality being liquidated. \textit{See} Standard Realization Co., 10 T.C. 708 (1948); Treas. Reg. § 1.368(b)(1955). \textit{But see} Rev. Rul. 63-29, 1963-1 Cum. Bull. 77.
Sale of Partnership Interest

If the developer entity is a partnership, rather than a corporation, different "collapsibility" rules apply. If all or some of the partners sell their partnership interests in the developer partnership to a third party, assuming they have been partners for more than six months, they will recognize a long-term capital gain except to the extent that their gain is attributable to their share of the partnership's "unrealized receivables" or "substantially appreciated inventory" under section 751(a). Under section 751(d), condominium units held by the partnership would undoubtedly be "inventory"; however, the units would be considered to have "appreciated substantially in value" only if their fair market value exceeds 120 percent of the adjusted basis to the partnership of the units, and 10 percent of the fair market value of all partnership property, other than money. Thus, if it can be established that the partnership's profit margin on resale of units will not exceed 20 percent of the partnership's basis in the units, the partners might be able to realize a capital gain upon sale of their partnership interests. If all of the partners sell their interests simultaneously, however, the IRS may attempt to thwart capital gains treatment by contending that, in effect, the assets of the partnership were sold.

If the sale-of-partnership-interest technique is considered, it will be advisable to conclude the sales prior to sale of a significant number of individual units, if such units are to be sold on an installment basis. Gain on the sale of partnership interests attributable to deferred gain on installment obligations would be taxable as ordinary income, since installment obligations are treated as "unrealized receivables" under section 751(c).

Other tax planning techniques should be considered by the developer of a nonresidential condominium including: (1) capitalization of construction interest and taxes under section 266 if the current deduction of such expenses is not valuable, e.g., if a Subchapter S corporation is used and the stockholders' basis is negligible; (2) careful selection of a fiscal year — if a regular corporation or Subchapter S corporation is used — to defer income and taxes thereon as much as possible; (3) installment sales of units requiring the seller-developer to

111 Note that if the partnership has deducted its construction expenses (interest, taxes, etc.), this will reduce its adjusted basis in the units and thus increase the likelihood that the units will be "substantially appreciated" in value. See Yourman v. United States, 277 F. Supp. 818 (S.D. Cal. 1967).

112 See Rev. Rul. 72-172, 1972-1 CUM. BULL. 265.

receive cash "payments" of no more than 30 percent of the purchase price in the year of sale in order to defer taxation.

**TAX PLANNING: UNIT PURCHASERS AND THE ASSOCIATION**

If a taxpayer uses a commercial condominium unit owned by him for the conduct of his own trade or business, or for rental to third parties for use in their trade or business, he may deduct real property taxes (which will be assessed directly against him), interest expense incurred by him on mortgages secured by his unit, and casualty losses suffered with respect to the unit. Other trade or business expenses, such as repair and current maintenance costs and the cost of property insurance, are deductible as well.¹¹⁴  

A major tax benefit available to a taxpayer with respect to a condominium used by him in his trade or business is that he is entitled to depreciate his investment in the unit.¹¹⁵ The depreciation rate is limited to straight line depreciation, except that in the case of a unit purchased in a newly constructed condominium as to which the taxpayer is the "first user", the taxpayer may, under section 167(j), use accelerated depreciation computed under the 150 percent declining balance method.

If the unit has been held for more than six months and is used in the taxpayer's own trade or business, or is rented to others, it will constitute section 1231 property. Thus, any gain or loss realized on the sale of the unit must be aggregated with his other section 1231 gains and losses. Any net section 1231 gains are taxed as long-term capital gain except to the extent of the recapture as ordinary income under section 1250 of depreciation deductions taken in excess of straight line depreciation.

Net section 1231 losses, on the other hand, are deductible as an ordinary deduction, not as a capital loss. Thus, if the unit owner should ultimately sell his unit at a loss, he will at least have the benefit of an ordinary deduction unless the loss is offset by section 1231 gains.

**Advantages in Unit Ownership**

In determining whether to purchase a condominium unit for commercial or industrial use, rather than to rent comparable space, one of the important factors to be considered by a potential purchaser is the

¹¹⁴ **Int. Rev. Code of 1954**, §§ 164 (real property taxes), 163 (interest expense), 165 (casualty losses), 162 (other business expenses). If the owner "net leases" the unit to another person, the interest payments may be subject to disallowance or deferral as "investment interest" under section 163(d).

¹¹⁵ **Id.**, § 167.
tax advantage afforded by ownership of a unit when compared to the tax benefit of renting. The key tax advantage of ownership of a unit results from the depreciation deduction, which is computed on the total price paid by the purchaser for the unit, including amounts paid through mortgage financing of the unit. Of course, part of the investment in the unit is allocable to nondepreciable land.

If the 150 percent declining balance method of depreciation is used, significant tax deductions may be provided to the unit owner in the initial years of ownership. Developers of commercial condominiums may be able to offer a purchaser even larger depreciation deductions by keeping accurate records of the costs of the various components of the building, which would put the developer in a position to furnish each unit purchaser with a computation of his share of the various cost components. In the case of a new office condominium, a purchaser of a unit should be able substantially to increase his depreciation deductions if he is able to use the component method of depreciation.

In evaluating the possible tax advantages of owning a unit, the purchaser should focus not only on whether the tax deductions resulting from depreciation, taxes, interest and maintenance are larger than the rental deductions would be for equivalent space in the first years, but he should, to the extent possible, also project the deductions over the assumed period of his ownership of the unit. At such time, as mortgage principal repayments begin to exceed depreciation, for instance, the tax-shelter advantages of depreciation will be lost, and the unit-owner may have to use after-tax dollars to make amortization payments.

Owning vs. Renting

In comparing the relative costs of owning a condominium unit rather than renting, various methods of analysis can be used. The purchaser might first compare on an annual basis the projected after-tax cash outlay for each as shown in the following table:

Projected after-tax cash outlay

Costs of owning unit:
1. Maintenance costs
2. Taxes (real estate)

116 The Service has recently reversed its former position and agreed that in appropriate circumstances component depreciation can be taken for used buildings. See Rev. Rul. 73-410, 1973 Int. Rev. Bull. No. 41, at 8. Thus, if the seller of a used commercial building can furnish accurate records of the various components used in the building to purchasers of units in a building which is being converted to condominium status, or an allocation of the purchase price can otherwise be made, the purchasers should be able to use the component method of depreciation.
3. Mortgage or deferred purchase price amortization payments
   (principal and interest)

Minus:
   1. Tax Savings from Deductible Payments\(^{117}\) and Depreciation

Equals:
   Total after-tax cash outlay

Costs of renting comparable space:
   1. Rent
   2. Rent or Occupancy Tax, if any

Minus:
   1. Tax Savings From Deductible Payments

Equals:
   Total after-tax cash outlay

In addition to the foregoing, the purchaser should consider the loss
of imputed income he suffers from the cash investment he must make,
after deduction of taxes he would pay on such imputed income, in
making a down payment and through mortgage amortization or de-
ferred purchase price payments. On the other hand, he may consider
that this loss of imputed income should be offset by the amount of his
mortgage amortization payments, which represent a build-up of his
equity in the office unit.

Although the results of any such comparisons will obviously vary
depending upon the assumptions used, e.g., the rate of return used to
calculate the loss of imputed income on the cash invested, it has been
contended by sponsors of various nonresidential condominiums that
purchase of a condominium unit will, at least in the initial years, in-
volve lower net after-tax occupancy costs to the purchaser than the
rental of comparable space. Prospective purchasers should review any
such projections with some skepticism, especially when the costs of
owning are reduced by such items as estimates of annual appreciation
of the value of the unit. On the other hand, it would not be unrealistic
to factor into the computation some reasonable assumptions concerning
annual appreciation in value of the condominium unit.\(^{118}\)

\(^{117}\) If a purchaser of a unit in a new condominium were able to obtain a deduction
for expenses (such as interest, real estate taxes, and sales taxes) incurred by the developer
with respect to construction of the unit, substantial tax savings might be achieved. This
would only be possible if the purchaser, directly or through a development partnership,
were the person on whose behalf the unit is being constructed. This appears impractical,
except perhaps in the case where a very small number of purchasers is involved.

\(^{118}\) See the analysis made in comparing the after-tax cost of owning, as opposed to
An attempt to compare the costs of owning a unit rather than renting also requires refinement to take into account special factors applicable to a particular purchaser. Thus, for example, a tax exempt organization should, under most state laws, be exempt from real estate taxes if it owns a unit, whereas it gets no such benefit from its exempt status if it rents comparable space. In addition, the tax deductibility benefit of rent is not useful to an exempt organization. Any purchaser who is not tax exempt must be sure that the tax rates used by the seller to demonstrate the relative costs of owning or leasing are applicable to it.

Advantages Over Other Forms

Section 216 authorizes the pass-through of real estate taxes, interest, and depreciation deductions to tenant-stockholders of a "cooperative housing corporation." To qualify as a "cooperative housing corporation," each of the corporation's stockholders must be entitled "to occupy for dwelling purposes" an apartment in the building. In addition, 80 percent of the corporation's gross income must be received from tenant-stockholders who must be individuals.\footnote{119} Therefore, section 216 would not be applicable to a predominantly nonresidential building. Accordingly, unlike owners of a condominium unit, shareholders of a cooperative corporation used primarily for nonresidential purposes would not be entitled to deductions for depreciation,\footnote{120} or for the pass-through of interest and tax deductions from the corporation.

Although a partnership or co-tenancy formed to own commercial property would qualify for pass-through treatment, it would not usually provide the same flexibility as a condominium in giving each participant the right to own and finance his particular office space. It thus appears that when a group of individuals or companies wish to own and finance that portion of a building which they occupy for business purposes, the condominium is the most advantageous form of ownership.

Owner Status

Although each unit owner has complete ownership of his own unit, generally all of the unit owners together own all common areas of the condominium. Under most condominium statutes, each of the

unit owners is a party to the condominium association, which, under the direction of the board of managers, is the unincorporated body that owns and administers all common areas, maintains and repairs the grounds and building, and is responsible for collecting the funds needed for such services. Recently, when state law permits, a separate management corporation, owned by the unit owners, has often been established in order, to the extent possible, to minimize the association's liability. Whether or not a separate management corporation is used, the unit owners will pay a monthly assessment to cover current maintenance, repairs and utility costs, as well as to cover capital replacements and improvements.

To the extent that assessments are received from unit owners solely to defray current maintenance expenses, no tax problems should arise. The Service has ruled that excess assessments received by a condominium management corporation are nontaxable to the corporation if they are either applied to the next year's assessments or returned to the unit owners; the same rule should apply a fortiori where no separate management corporation is used.\(^{121}\)

The above ruling did not deal, however, with the situation where a condominium management corporation receives assessments which, because they are to be held in reserve for future capital expenditures, are not expended in the year received or in the next year.\(^{122}\) Nor is it likely that the ruling would protect a management corporation from taxation upon the receipt of funds which are expended in the year of receipt on capital improvements rather than deductible expenses. Will a condominium management corporation be taxable on such assessments? It appears unlikely that the corporation could claim tax exempt status. Just as the Service denied a residential condominium management association tax exempt status under section 501(c)(4) because it was considered organized for the private benefit of its members,\(^{123}\) so, too, it seems that a commercial condominium association or management corporation would not be granted tax-exempt status as a business league under section 501(c)(6).\(^{124}\) Nevertheless, under section 118, if a member of a commercial condominium association makes a capital contribution to the management corporation or to the association itself to be used or set aside as a reserve for capital improvements, that amount


\(^{122}\) Id.


should be excluded from gross income of the recipient. Although there is no published authority on this issue, the result should follow from the decisions which have held that amounts contributed by tenant-stockholders of cooperative housing corporations to be used for mortgage amortization are nontaxable contributions to capital.

Thus, a careful designation by the board of directors of a management corporation or by the board of managers of an association that assessments are being received as capital contributions and are being set aside for such purposes should eliminate or substantially reduce the risk of taxation. An alternative contention for nontaxability of such amounts would be based on the cases which have held that the amounts are received by a corporation with a definite restriction as to use and the funds are utilized solely for that purpose, the amounts are held as a trust fund and, therefore, the recipient corporation, as a conduit or agent, is not taxable on the funds. In light of certain recent rulings, however, it appears that the Service may well refuse to follow the trust fund theory in the commercial condominium context.

If a condominium management corporation realizes investment income from investment of its reserves, the investment income will be includible in the corporation's gross income. In the case of a management corporation owned by residential condominium unit owners, it seems clear that, under section 277, such investment income cannot be offset by expenses incurred to provide services to the unit owners. Although not entirely clear, it seems that section 277 would also be deemed applicable to a management corporation owned by commercial condominium unit owners, and therefore that investment income could not be offset by expenses related to providing services for the unit owners.

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126 In response to questions raised by certain Florida residential condominium associations, the Service has apparently issued informal letter rulings on this issue suggesting that a designation of the funds as a contribution to capital will work.

127 See, e.g., Eckstein v. United States, 452 F.2d 1036, 1041-44 (Ct. Cl. 1971).

128 See, e.g., Park Place, Inc., 57 T.C. 767 (1972); Seven-Up Co., 14 T.C. 965 (1950).


130 INT. REV. CODE OF 1954, § 277, adopted in 1969, provides that 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 attributable to furnishing services, facilities, etc., to members are allowed only to the extent of the gross income derived from members. The proposed regulations take the view that section 277 is applicable to any "taxable organization operated on a mutual, co-operative, or similar basis whose primary activity is providing members with services, facilities or goods." Proposed Treas. Reg. § 1.277-1(b)(1), 37 Fed. Reg. 9278 (1972).
If an unincorporated association receives income from investment of its reserves, but has no other outside income, it is unclear whether the investment income will be included in its gross income or whether a proportionate part should be reported by each of the unit owners. Arguably, when a condominium association has no outside income except income from investment of its reserves, it is not taxable as a separate corporate entity since it is not engaging in business for joint profit.\textsuperscript{131}

Outside Rental Income

Certain additional tax problems are raised if a commercial condominium association receives rental income from the rental of commonly owned space to outsiders. The basic tax question may be stated as follows: will a portion of the rental income received by the association be taxable directly to each owner, or will such rental income be considered income of the association because it is taxable as a corporation under the regulations governing the taxation of associations treated as corporations?

Under the association Regulations, which set forth the factors to be considered in determining corporate status, an unincorporated association which has associates and a purpose to engage in business will be considered taxable as a corporation if three of the following four corporate characteristics are present: (a) continuity of life; (b) centralization of management; (c) limited liability; and (d) freely transferable interests.\textsuperscript{132}

\textit{Continuity of life}. The great majority of condominium enabling acts as well as the condominium documents themselves prohibit partition except in the case of destruction of the property. In the absence of contrary agreement, death, insanity, and bankruptcy of any member will not cause the dissolution or termination of the association's existence. To escape the corporate characteristic of continuity of life, it would probably be necessary to provide in the condominium agreement that any member may be expelled for cause. This, however, would seem to be unacceptable in a commercial condominium.

\textit{Centralization of management}. At least with respect to larger con-


\textsuperscript{132} Treas. Reg. § 301.7701-2 (1965). There have been indications recently that the Service may be considering amending these Regulations to provide that if two of these corporate characteristics are present, an association will be taxable as a corporation.
dominiums, while it may be possible for all members to participate in the decision of major questions, it is likely that day-to-day operational decisions must be delegated to a board of managers. Under the Regulations, if the decisions of the board of managers can be limited to "ministerial" decisions and all other decisions, e.g., the rent to be charged on leases of space to outsiders, must be approved by the members, then the characteristic of centralized management may be negated.\(^{133}\) Except for small condominiums, however, it seems unlikely and impractical that all members will participate in all non-ministerial decisions. Thus, while it is unclear, it would seem difficult for a commercial condominium to avoid centralization of management.

**Limited liability.** In most states, a unit owner is directly liable for all contract and tort liabilities of the association. It thus would appear that the corporate characteristic of limited liability does not exist in a condominium, except in those few states where the unit owners are exculpated from liability by statute.\(^{134}\)

**Free transferability of interests.** An organization has the characteristic of free transferability if each member has the power, without consent of the others, to transfer his interests to another and substitute such transferee into the organization.\(^{135}\) In residential condominiums, it may be possible, and even desirable, to restrict free transferability by, for instance, a buy-sell agreement, a requirement of consent to a transfer, or a right of first refusal. It is doubtful, however, that such restrictions could effectively be imposed in a normal commercial condominium setting without substantially impairing the value of the unit. Thus, it seems that, as an economic matter, free transferability will usually exist in a commercial condominium.\(^{136}\)

It appears that there is a significant likelihood that a condominium association consisting of owners of units used for commercial purposes will be characterized as an association taxable as a corporation, especially in those states where the unit owners have limited liability. It may be possible at least in some smaller commercial condominiums to require sufficient participation by each member in the decisions of the association so that the characteristic of centralized management is

\(^{133}\) Id. § 301.7701-2(c)(3).


\(^{136}\) Although it might be possible to provide the other unit owners with a right of first refusal to buy a prospective seller's unit, such a right of first refusal would not be sufficient of itself to make the interests not freely transferable. If such "modified transferability" exists, the Regulations take the position only that less significance is attached to this characteristic in evaluating the corporate status of the organization. Id.
negated. But, to assure non-corporate status, it would also be necessary to provide for expulsion of members for cause (thereby negating continuity of life) or substantial restrictions on transferability of the units (thereby negating free transferability).

Since the separately owned units are, of course, not held for the joint profit of all unit owners and interest, taxes and maintenance expenses are paid directly by the unit owners, the deductions allocable thereto will not be treated as deductions of the association. However, if the commonly held rental property is considered held by an association taxable as a corporation, the unit owners could lose their right to deduct their share of the interest, taxes, and depreciation allocable to the common property, since all of these deductions arguably must be allocated to the "corporate" association. The rental income would be taxed to the association at corporate tax rates. Assuming that section 277 is applicable, however, the association would probably not be allowed to deduct against the rental income received by it amounts expended by it for the benefit of the unit owners. Thus, the association's income would be reduced only by expenses (including depreciation) incurred by it in realizing the rental income. Moreover, use of the net rental income by the "corporate" association to pay expenses which otherwise would be allocable to the unit owners would probably be taxable as a constructive dividend to them to the extent of the association's "earnings and profits."

Where substantial commonly owned property is to be rented, the unit owners might grant a formal "net lease" of the area to a management company or to a separately incorporated rental corporation, which would be formed to enter into lease arrangements for the common areas. The separate rental corporation or management company would pay the unit owners a fair "net" rental, and would be taxable on the excess rental received from the lessees of the rental area. The lease from the unit owners might be granted to the sponsor-developer, who in turn would form a management company and undertake to lease the space to third parties. At a later date, the developer might be able to sell the lease or the management company's stock for a capital gain.

By "net leasing" the common area to a separate management company which will handle all rentals and maintain the common rental area, the association may have limited its own activity sufficiently so

137 See Treas. Reg. § 301.7701-2(a)(2) (1965); Krasnowiecki, supra note 131, at 345.
138 Alternatively, the Service may contend that the corporate association is not entitled to deduct such expenses since the condominium association taxable as a corporation is not the owner of the property. See I ROHAN & RESKIN, § 15.06(3).
that it would no longer be taxed as a corporation. Arguably, although it is probable that the Service would not agree with this contention, where the association merely collects net rental income from the management company and engages in no business activity through agents, the association will not be carrying on a business for joint profit and therefore will not be taxed as a corporation.\footnote{140}

In the last few years, a technique has been developed for resort condominiums involving rental pool arrangements which suggests that a possible approach in circumstances where substantial common rental income is expected may be the formation of a separate limited partnership consisting of each of the unit owners as limited partners and a management company or the developer as the general partner.\footnote{141} If each of the unit owners contributes the right to use his portion of the commonly owned rental property to a limited partnership and receives in return an interest in the limited partnership's profits and losses, it may be possible to structure the limited partnership so that it is not taxable as a corporation. The principal difference between such a limited partnership and the condominium association itself is that the partnership can be formed so that it probably does not have the corporate characteristic of continuity of life, since the limited partnership agreement will provide that the partnership will be dissolved upon the death, retirement, bankruptcy, etc., of the general partner. It should be possible for the partnership to avoid the corporate characteristic of limited liability as well. Thus, even if the limited partnership has the corporate characteristics of (1) freely transferable interests because the limited partnership interests probably will automatically be transferred to the new unit owner upon sale of a unit\footnote{142} and (2) centralized management, it should nevertheless be taxed as a partnership because it has

\begin{footnotes}
\footnote{140}{It has been suggested that, based on certain court decisions, the rental of real property under a net lease will not constitute engaging in business if the lessor, directly or through an agent, is not involved in any management activity. \textit{See} Lee, "\textit{Active Conduct}" Distinguished from "\textit{Conduct}" of a Rental Real Estate Business, 25 \textit{TAX L.} 317, 322-24 (1972). \textit{See also} Treas. Reg. \S 1.761-1(a)(1), T.D. 7208, 37 Fed. Reg. 20686 (1972).}
\footnote{141}{\textit{See} Treas. Reg. \S 301.7701-2(a)(2) (1965). \textit{But see} Rev. Rul. 74-319, 1974 Int. Rev. Bull. No. 27, at 10, where the Service took the position that an advertising fund established by franchised dealers is treated as an association taxable as a corporation even though it did not have "an objective to carry on business for joint profit," which is one of the essential corporate characteristics the absence of which should allow an association to avoid taxation as a corporation under Treas. Reg. 301.7701-2(a)(2).}
\footnote{142}{\textit{See}, e.g., Offering Plan, Camelback Inn Associates and Montaneros, \textit{reprinted in Practicing Law Institute, Resort Condominiums} N4-3301 (1973).}
\footnote{143}{It should also be possible to make the interests not "readily transferable" by providing that even though they are automatically assignable to a purchaser of a unit, the purchaser will not become a substitute limited partner without consent of the general partner. \textit{See} Treas. Reg. \S\S 301.7701-2(c)(1), -3(b)(2), Example (1) (1965).}
\end{footnotes}
two noncorporate characteristics. Thus, there should be no corporate tax applicable to the partnership's net rental income, which will be taxed directly to the unit owners as limited partners.

It appears that, under most condominium statutes, it may not be feasible for the unit owners actually to transfer their share of the commonly owned rental property to the partnership since that would involve a severance of the commonly owned rental property from the condominium association. However, if each of the unit owners contributes to the partnership the right to use his portion of the commonly owned rental property for a specific period of time, this would be analogous to a rent-free lease of the commonly owned rental property to the partnership. Thus, it would seem that depreciation as well as any other expenses paid by the unit owners with respect to the common area would continue to be deductible by them on their own returns.

The most troublesome aspect of this approach is that, because he is offering limited partnership interests as well as condominium units, the developer may be subject to the requirement of registering the offering under the federal securities laws. Perhaps the simplest way to avoid the foregoing complications is for the developer at the outset to divide into separate units that part of the common areas, such as the lobby floor of an office building, which will be used for commercial purposes. If he then sells these units or retains them, the possible adverse tax consequences to the other unit owners should be avoided or at least minimized. If he wants to make available to the other unit owners the potential economic benefit of that space, he might offer to sell the units to one or more of them.

Conclusion

While few commercial or industrial projects were marketed in the first decade of condominium experience, there is every indication that such projects will appear with growing frequency in the years to come. As has been demonstrated, the condominium concept possesses mutual advantages to the developer as well as the unit owner. Marketing, tax and other financial advantages of the condominium demand examination by anyone considering the construction of a new professional center, office building, shopping center or factory. Likewise, the pro-

144 But see note 132 supra.
145 See SEC Securities Act Release No. 5347 (Jan. 4, 1973). The possible applicability of the requirements of federal securities laws should be considered in any situation where the income to be derived from ownership of common rental area is expected to be substantial.
spective commercial tenant must now explore the benefits of a prestige equity investment which will no doubt increase in value. Many of the headaches of traditional forms of ownership are eliminated through the professional management of the premises which the condominium offers.

It is fair to speculate that in coming years, the commercial condominium will attract the imaginations of architects, urban planners and forward-looking businessmen. From the standpoint of the legal profession, this development will require reexamination of enabling legislation, tax considerations and lending policies so as to provide a more favorable climate for this exciting concept.