Portfolio 596-4th: Residential Cooperative and Condominiums Selected Documents

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This Portfolio revises and supersedes 596-3rd T.M., *Cooperative and Condominium Apartments*. Portfolio 596-3rd T.M. should be discarded.

U.S. Income Portfolios
U.S. Income Portfolios: Real Estate
Portfolio 596-4th: Residential Cooperative and Condominiums
Portfolio Description

Description

PORTFOLIO DESCRIPTION —

Tax Management Portfolio, *Residential Cooperatives and Condominiums*, No. 596-4th, examines federal income consequences of two forms of common ownership interests[1] in a residential unit of a larger development, the cooperative unit and the condominium unit. The cooperative unit is a shareholder interest, coupled with a leasehold right to the specific residential unit, in a C corporation — called the cooperative housing corporation or cooperative corporation — that holds fee title to the entire property. Alternatively, the condominium unit is a direct fee ownership interest in the residential unit.

[1] A hybrid form of entity, the "condop" is a residential cooperative within a condominium or vice versa. It facilitates the mixed residential and commercial use of a larger building.

This Portfolio addresses federal income tax consequences of each of these ownership interests with a focus on the more complex tax provisions applicable to the cooperative housing corporation found in Section 216 of the Internal Revenue Code specifically and, more generally, in Subchapter T of the Code. The laws of some states require in an offering of residential units to the public a formal written discussion of the important legal and tax issues, generally including a tax opinion from outside counsel, to prospective unit-owners from the purchase of a cooperative or condominium unit. The discussions relating to tax matters focus on the rights of unit holders to interest deductions, property tax deductions and, in the case of sale of the unit, the exemption amount allowable from gain on subsequent sale of the unit. In the case of the cooperative housing corporation specifically, a detailed analysis as to whether the corporation qualifies under §216 as a cooperative housing corporation is also included in the discussion as it forms the predicate for a unit holder's tax benefits. While often thorough and complex, the discussions do not cover the full range of issues we see among many interested parties to a cooperative or condominium.

Qualification of corporation as a cooperative housing corporation under §216 (and the shareholder as a "tenant-stockholder" under a less arduous test in §216) affords the unit-owner four basic statutory tax benefits designed to put the cooperative share owner, in their capacity as residential occupants, in a comparable tax position to the fee owner of individual housing property or condominium unit. Specifically he/she is granted the right under §216 to claim a deduction for their share of the cooperative's interest deduction on its mortgage or other secured interest and property taxes and, in two related sections of the Code, to claim a deduction for qualified residence interest under §163(h)(4)(B) attributable

to interest on their purchase indebtedness for the unit and the §121(d)(4) $250,000/$500,000 exemption on sale of the unit. The first 13 chapters of this Portfolio will address the basic requirements under §216 to qualify as a cooperative housing corporation (and its owners as tenant-stockholders) and the four basic statutory tax benefits afforded unit owners in their capacity as residential occupants. Since the cooperative is a Subchapter C taxable entity and, in accordance with certain judicial decisions, also subject to the benefits and burdens of Subchapter T, it will also address its income and deduction issues arising from income from operations such as the receipt of shareholder rent and third-party income and related loss. The condominium management association is covered in this first part. It is helpful for a fuller understanding of the cooperative provisions to include in the analysis of income from operations a discussion of common commercial transactions a cooperative may engage in, such as rental of first floor space to a retail store, to get a fuller understanding of certain of the statutory requirements and they are included in the first 13 chapters for this purpose. Chapter XIII focuses on issues developers face in building or converting rental buildings to a housing corporation regime.

Chapter XIV of this Portfolio focuses on certain capital transactions in connection with the premises that may arise one or more times, or not at all, over the lifetime of the cooperative and condominium including: (1) On the entity asset or shareholder stock sale side — (A) conversion of a cooperative to a condominium in a single transaction or as converted piecemeal over time at the election of each of the unit owners, with variations employing the conversion on the buy side or sell side of a planned unit owners' group sale of the entire premises to a developer, each with the goal of avoidance of cooperative entity tax otherwise applicable under §311 of the Code through qualification under §216(e) and (B) the potential availability of the Subchapter T patronage deduction to permit a broader range of cooperative tax minimization arising from entity fee level transfers beyond conversion to condominium that might include an all cash entity sale of the entire premises to a developer and the tax consequences to shareholders from these transactions; (2) On the investor buy side — the developer's or other investor's (to include existing long-term commercial lessees) qualification under §216(c) for depreciation on a portion of the value of its stock purchase (where stock is acquired), whether from unit owners or the cooperative, the investors' non-statutory eligibility for §1031 exchange treatment for their stock, existing owners' tax consequences from any receipt of such investor funds and, separately, development issues arising under general Subchapter C provisions; (3) Whether the cooperative can use its losses from residential owner income against income or gain from commercial rental income or sale of development rights; and (4) sale of a single condominium unit in a mixed-use rental building.

Many co-op owners and others not practicing in this field, refer to the cooperative as a "pass-through" entity because of the tax benefits provided unit owners and are surprised to learn of potential large and in some cases catastrophic tax consequences when an entity transaction, such as conversion to condominium or sale of the assets, arises. Throughout this Portfolio, as we examine treatment of the cooperative and its owners, we note the difference in tax treatment from other pass-through entities and in not all cases does the cooperative come up short.

This Portfolio may be cited as Stone, Saft, and Covitt, 596-4th T.M., *Residential Cooperative and Condominiums*.

Portfolio Description

Table of Contents

1. Every Shareholder
2. Time Sharing
3. Summary of Necessary Elements
4. The Stock-as-Source Element
   a. Allocation of Shares
   b. Effect of Requiring Proprietary Lease
   c. Other Sources
5. The Owned-by-Corporation Element
6. The Necessary-Rights Element
   a. As Against the Corporation
   b. Exclusion Right
   c. Live-In Right in General
   d. Cases Where No Live-In Right Required
7. The Actual-Eligible-Space Element
   a. Existence of the Space
   b. What Spaces Are Eligible
      (1) Two Different Approaches Considered by the IRS
      (2) The “House” and “Apartment” Rulings
      (3) Revenue Ruling 90-35
      (4) Inclusion of Other Space

F. The No-Entitlement-to-Distribution Requirement (§216(b)(1)(C))

1. Meaning of “Entitled”
2. “Good” and “Bad” Distributions
3. No Requirement of “Good” Distributions
4. Constructive Distributions

G. The One-of-Three-Percentages Requirement (§216(b)(1)(D))

1. The 80% Square Footage Test

4. Subchapter T Limits on Deductions

a. In General

b. Subchapter T as Applicable to Commercial Cooperative Housing Rental Income

B. Section 216(e) — Cooperative-to-Condominium Conversion

1. Introduction

2. Possible Relief Under §216(e)

a. Introduction

b. Analysis of §216(e)

(1) Potential Regulatory Limitations

(2) The Corporate-Qualification Issue

(3) The Dwelling-Unit-in-Exchange Issue

(4) The Used-as-Principal-Residence Issue

(a) Seller-Side Cooperative-Unit-to-Condominium-Unit Conversion

(b) Buyer-Side Cooperative-Unit-to-Condominium-Unit Conversion

C. Certain Subchapter C-Related Issues

1. Amounts Refunded to Shareholders

a. Actual Return in Same Year

b. Credit Against Later Charges

2. Amounts Held as Agent

3. Payments Received for Stock (§1032)

4. Capital Contributions (§118)

a. The IRS Position

b. Need Not Be Voluntary

c. Enforcement Mechanism Irrelevant

d. The Purpose Test

e. The Tracing Problem

f. Voluntary Characterization as Rent

VIII. Taxation of “Cooperative Housing Corporation”

This chapter VIII. focuses on a variety of issues ranging from income from operations of a cooperative housing corporation to the assessment of shareholders for capital improvements over the life of the building. This chapter also analyzes the consequences of simply converting a cooperative to a condominium. Income from certain capital events involving third parties, like the sale of the building in liquidation, sale of development rights, sale of shares to a commercial enterprise, conversion to condominium for sale to a developer and other “one-off” matters that may occur during the life cycle of a building are covered in chapter XIV. [417]

[417] This chapter also covers third-party capital events for condominiums.

The cooperative housing corporation tax provisions,[418] designed to put tenant-stockholders in rough tax parity with single-family or condominium owners, do not address the taxation of the corporation. Other aspects of cooperative housing taxation, in their capacity as C corporations, are also briefly covered.[419] In short, there is no special Code section that deals comprehensively with the income taxation of a “cooperative housing corporation” as such.[420] Rather, a “cooperative housing corporation” is subject to income tax, essentially in the same manner as any other corporation.[421] However, there are three provisions of tax law applicable to cooperative housing corporations that generally do not apply to a garden variety C corporation. The first is the 1969 addition of §277 to the Code, the second the 1988 addition to the Code §216(e), and the third are the judicial determinations in 1995 and 1996 that housing cooperatives are subject to Subchapter T [Taxation of Cooperatives]. We focus on these three items in this chapter and briefly cover other issues that arise in the normal Subchapter C settings.[422]

[418] §216. The deductions for "tenant-stockholders" are discussed at length in IV.A, above.

[419] In general, they are no different than those of other C corporations. Note that Subchapter T does not supplant Subchapter C to the extent the Subchapter T provisions do not apply. See for example PLR 200541003 (conversion of a cooperative to a C corporation is an "F" reorganization). This is similar to the application of Subchapter C to S corporations to the extent not inconsistent, which the readers may be more familiar with. §1371(a).

[420] *See Concord Consumers Hous. Coop. v. Commissioner*, 89 T.C. 105 (1987) (concurring opinion). Section 216(e), which is discussed at some length at VIII.B., below, does in a certain very limited situation provide a "cooperative housing corporation" relief from one very specific kind of corporate-level income taxation.

[421] *E.g., Eckstein v. United States*, 452 F.2d 1036 (Ct. Cl. 1971); *Grutman v. Commissioner*, 80 T.C. 464 (1983); *Concord Vill., Inc. v. Commissioner*, 65 T.C. 142 (1975), *appeal dism'd* (9th Cir. 1977); Rev. Rul. 65-201; S. Rep. No. 938, 94th Cong., 2d Sess. 397 (1976) ("Cooperative housing corporations . . . have a long history of being treated as taxable organizations."); *PLR 5503165850A* (one of two different private letter rulings issued on the same date and with the same number) ("There is no provision in the Code or regulations under which a cooperative housing corporation . . . would be exempt from Federal income taxes."). The IRS ruled that a "cooperative housing corporation" is permitted to file a consolidated return. PLR 8051101. The usual corporate rules apply. *See, e.g.,* PLR 9149016 (reorganization).

[422] In general, they are no different than those of other C corporations. Note that Subchapter T does not supplant Subchapter C to the extent the Subchapter T provisions do not apply. *See, e.g.,* PLR 200541003 (conversion of cooperative to C corporation is "F" reorganization). This is similar to the application of Subchapter C to S corporations to the extent not inconsistent, which the readers may be more familiar with. §1371(a).

A. Section 277 and Subchapter T

1. Overview of §277 and Subchapter T —

While C corporations are taxed at two levels (first, taxed at the corporate level, and again at the shareholder level), the typical cooperative housing corporation charges rents/maintenance amounts to its stockholders only in amounts necessary to cover costs,[423] leaving little if anything in the way of taxable income for the year where no third-party income arises, and little or nothing in the way of available cash for distributions to shareholders.

[423] *See* VIII.B.1., below. Depreciation on the building is also available. §216(c)(1) (last sentence).

Where third-party income arises, the cooperative housing corporation can be subject to tax in a manner less advantageous than that of a normal C corporation due to the requirement that it segregate income and losses generated from shareholder rent[424] from third-party-generated income. The cooperative housing corporation is also treated as a non-exempt cooperative under Subchapter T of the Code.[425] The focus of the opinions was limited to the application of Subchapter T to the entity and the differences such status causes with respect to the allowance of corporate deductions

arising from shareholder rental losses used against certain interest income.[426] This chapter will examine those cases and analyze their application to a much larger concern for many cooperatives, the allowance of shareholder generated rental losses against third-party commercial rental income. In this chapter, we will consider the as-yet untested judicial analysis of the allowance of deductions for distributions of Subchapter T patronage dividends by a cooperative housing corporation to eliminate or lessen income from certain capital events.[427]

[424] Shareholder rent, due to the limited amount collected to cover costs under cooperative practices, often results in a taxable loss. Such loss may not be deductible against third-party income under principles discussed below. §277.

[425] *Trump Village Section 3, Inc. v. Commissioner*, T.C. Memo 1995-281; *Thwaites Terrace House Owners Corp. v. Commissioner*, T.C. Memo 1996-406. To date there are no contrary authorities.

[426] Section 277, and to some extent, Subchapter T, limit the right of the corporation to use its NOLs from shareholder rent/maintenance against third-party income. As we will see, Subchapter T provides a somewhat easier standard to use the shareholder generated NOLs.

[427] There we will look at taxable income from a large sale or other capital event that would arise even with the full use of the cooperative's NOLs from shareholder generated rents and the proceeds of which are intended to be distributed in whole or in part to shareholders/patrons.

It is worth noting in the general tax analysis of cooperatives and condominiums that, in addition to complex tax differences between an owner's direct fee ownership in a condo unit and their indirect fee ownership in a cooperative housing unit discussed in the II. and III., above, complexity in this area of the tax law is further increased by the economic difference often resulting from the ownership of the common elements of condominiums and cooperatives. That distinction most notably arises in the case of non-stockholder, i.e. commercial, rental income.[428]

[428] In a typical scenario, cooperative rental income from non-stockholder retail space is economically owned by all stockholders from their percentage ownership interest in the common elements of the cooperative building. In contrast, retail space in a condominium is typically owned directly by a single condominium unit owner (the “Retail Unit” owner in condominium parlance) and is not common interest of the residential owners. Thus, the examination of the cooperative entity's taxation reflects both the tax distinction of ownership and, where applicable, the economic difference arising from third-party income. While typical, it is not universal. As we also discussed, some otherwise common element commercial space in a cooperative housing corporation may (1) be eligible with minor renovation to constitute “apartment” equivalent space that would support issuance of qualified tenant-stockholder shares, and (2) such shares may in fact have been purchased by a commercial enterprise, making it in effect economically equivalent to the Retail Unit of a condominium. Alternatively, retail space in a condominium could be common element space.

2. Section 277

a. Application to Cooperative Housing Corporations —

Prior to the issuance of *Trump Village* and *Thwaites*, the Tax Court had determined that §277 did not apply to corporations subject to Subchapter T.[429] To fully grasp why taxpayers brought litigation in *Trump Village* and *Thwaites* for a determination that cooperative housing corporations were subject to Subchapter T, and therefore under *Buckeye Countrymark* not subject to §277, it is useful to examine the consequences that §277 had on housing cooperatives.

[429] *Buckeye Countrymark, Inc. v. Commissioner*, 103 T.C. 547, 615 (1994). The decision

provides a detailed analysis as to why §277 is not compatible with Subchapter T, but for our purposes we need only know that §277 does not apply to any cooperative housing corporation subject to Subchapter T.

Section 277 was added to the Code in 1969 and had been applied to cooperative housing corporations shortly thereafter. The statute provides in relevant part:

> In the case of a . . . membership organization which is operated primarily to furnish services . . . to members . . ., deductions . . . attributable to furnishing services . . . to members shall be allowed only to the extent of income derived . . . from members. . . .[430]

[430] *See also* TAM 9637007 (§277(a) applies to taxpayer, a non-exempt golf and country club, and income from the taxpayer's sales of condominium units to its own members is member income). The same subsection provides that, "[i]f for any taxable year such deductions exceed such income, the excess shall be treated as a deduction attributable to furnishing services, insurance, goods, or other items of value to members paid or incurred in the succeeding taxable year." No carryback is permitted. And any carried-forward potential deductions are of course subject to the application of the section in that year (and another carryforward). Inasmuch as, even without taking any §277 carryforward into account, potential deductions from dealing with members will in every year normally exceed income from members, it is likely that such carryforwards will only rarely be used by an ongoing housing cooperative. *See also* PLR 9428006 (§277(a) applied to liquidating §216 cooperative corporation in permitting cooperative to use accumulated excess §277 deductions to offset membership gain from liquidation).

The exact import of the §277 provisions to cooperative housing corporations was a little uncertain. In 1976, however, when Congress added language making it clear that a "cooperative housing corporation's" depreciation deduction was not affected by the fact that in an appropriate case a "tenant-stockholder" could also depreciate their stock,[431] it did not deal with the problem of whether the amount of the corporation's depreciation deduction should be limited. The Senate Finance Committee's explanation was as follows:

[431] §216(c)(1).

> The committee does not believe that a clarification of the rules relating to the cooperative housing corporation's ability to take depreciation deductions with respect to property leased to tenant-stockholders will create tax avoidance possibilities because the provisions of existing law (§277) generally prevent non-exempt membership organizations from offsetting non-member income with losses from dealings with members.[432]

[432] S. Rep. No. 938, 94th Cong., 2d Sess. 397–98 (1976).

Thus, the Senate Finance Committee clearly proceeded upon the assumption that §277(a) applied to housing cooperatives. Also, a district court applied §277(a) to a housing cooperative.[433] The Tax Court did the same in *Concord Consumers*.[434]

[433] *Shore Drive Apts., Inc. v. United States*, 76-2 USTC ¶9808 (M.D. Fla. 1976).

[434] *Concord Consumers Housing Cooperative v. Commissioner*, 89 T.C. 105 (1987).

The IRS later said in a technical advice memorandum: "Section 277(a) thus prevents nonexempt membership corporations from operating membership activities at a loss in order [to offset] nonmembership income."[435] In

consequence, a housing cooperative may find itself in the position of having more potential deductions (including those from its member activity) but still being required to pay income tax (on its net income from its nonmember activity).

[435] TAM 9637007.

Note: Section 277(a) only disallows the use of excess deductions from a member activity against non-member income, not the other way around. Where an organization subject to the section has a "loss from transactions with nonmembers," that loss "is fully deductible against both nonmember income and member income."[436]

[436] Rev. Rul. 2003-73. The contrary statement in TAM 9637007 is plainly incorrect.

b. Revenue Ruling 90-36 —

In Rev. Rul. 90-36, the IRS specifically dealt with some aspects of how it would apply §277(a) to a housing cooperative.

The ruling points out both (1) that a subject-to-§277(a) housing cooperative that has non-member dealings must allocate its expenses between its member and non-member dealings, and (2) that the IRS had theretofore promulgated no hard and fast rules to govern such an allocation.[437] It gives but one example, and in that example the cooperative's only income from non-member sources is commercial rent, but that source of income generally raises the greatest concern for those cooperatives with third-party non-member income. "In many [of such] cases," the ruling says, "an allocation based on the relative fair market values of the space used by the tenant-stockholders and the non-tenant-stockholders will be reasonable." It quickly adds that "[o]ther methods of allocating the expenses . . . may be appropriate."

[437] Indeed, so reluctant is the IRS to commit itself to rules that even its fence-sitting statement in Rev. Rul. 90-36 that "the proper allocation of expenses under §277(a) will depend on the facts and circumstances" is qualified by the word "generally"! No clue is given as to when such an allocation will not depend upon the facts and circumstances.

In point of fact, the sample allocation made in the ruling is not based on relative fair market values of the spaces. Instead, the allocation is made strictly on the basis of the relative sizes of the spaces.[438] In Rev. Rul. 90-36, the IRS finds such an allocation method "reasonable," at least as to such a cooperative's "fixed expenses and general operating expenses." By way of example, it includes in the former category real estate taxes, mortgage interest, and the corporation's depreciation deduction.

[438] *Cf.* Reg. §1.216-2(d) *Ex.* (2), which uses a space-used allocation method for purposes of computing the corporation's depreciation deduction.

It is probable, though, that the IRS's treatment of the space-used method of allocation in Rev. Rul. 90-36 will be of little significance. In view of the fact that the per-square-foot rental value of commercial space is normally several times that of proprietary space,[439] it is to be expected that virtually every cooperative with substantial commercial rental income will opt for the relative-rental-values approach that Rev. Rul. 90-36 authorizes so that greater amounts of the corporation's deductions may be allocated to the third-party profitable rental income.

[439] Even in the example given in Rev. Rul. 90-36 itself, the per-square-foot rental commanded by the commercial space is two and one-half times the per-square-foot rental received for the apartments.

For a variety of reasons, it may be important to determine just which potential deductions are being disallowed for the current year. And that is, or at least may be, of special significance in the case of a housing cooperative qualified under §216(b)(1), inasmuch as only certain specified amounts — i.e., certain described portions (but not necessarily all) of "the real estate taxes allowable as a deduction to the corporation under section 164" and certain described portions (again not necessarily all) of "the interest allowable as a deduction to the corporation under section 163" — can generate §216(a) deductions for "tenant-stockholders."[440] One would have thought that the IRS would have required that the customary strictly proportionate approach be used for this purpose, which, in view of its inherent fairness, would have provided little ground for complaint. Surprisingly, though, in Rev. Rul. 90-36, the IRS promulgates the following generous rule:

> [440] Since the term "allowable" is used, rather than "allowed," what is actually done at the corporate level is presumably not binding on the "tenant-stockholders." As a separate matter, "tenant-stockholders" may contend that the determination of whether or not a deduction is "allowable . . . under" one of those sections is to be made independent of the limitation imposed by §277, which would mean that the "tenant-stockholders" as a group might be able to deduct more than the corporation, but it seems likely that the ruling's implicit rejection of such a construction would be sustained.

> To minimize the conflict between the application of the deduction disallowance provisions in section 277 of the Code to section 216 cooperative housing corporation deductions at the corporate level and the deduction pass-through objectives of section 216(a) at the tenant stockholder level, amounts disallowed under section 277 will be deemed attributable first to expenses other than interest and real estate taxes (to the extent of such other expenses), and then to interest and real estate taxes if such attribution to the other expenses is used fully. Thus, amounts allowed in the first year (*i.e.,* amounts not disallowed under section 277) will be deemed attributable first to interest and real estate taxes, and then to expenses other than interest and real estate taxes.[441]

> [441] Although, regrettably, the ruling does not say so, all references to "interest and real estate taxes" are presumably meant to be only to those portions of such amounts that can generate §216(a) deductions. Also, recognizing that further identification within either the "interest and real estate taxes" category or the "other" category could conceivably make a difference for some purposes, the ruling continues as follows: "To determine the amount of each type of deduction allowed a cooperative housing corporation each year, a proportionate part of the amount disallowed under section 277 which is deemed attributable to a category of expenses is allowed to each type of expenses in the category." Query whether, in view of the IRS's obvious intention of being helpful to the members of §277(a)-subject "cooperative housing corporations in Rev. Rul. 90-36, the IRS would allow different allocations if desired by them. A possible reason might be to reduce state or local taxes. *See, e.g.,* former N.Y. Tax Law §208, subd. 9(b)(5).

In the example given in the ruling, such other expenses (including the depreciation allocable to the portion of the building used by the corporation's members) were more than the amount currently disallowed, with the result that the "tenant-stockholders" §216(a) deductions were unaffected by the application of §277(a).

c. Investment Income —

As of this writing, there have been two reported cases dealing with the issue of whether investment returns of a housing cooperative are member or non-member income for purposes of §277(a).[442] Both of them held such returns to be non-member income.

[442] *Shore Drive Apts., Inc. v. United States*, 76-2 USTC ¶9808 (M.D. Fla. 1976); *Concord Consumers Housing Cooperative v. Commissioner*, 89 T.C. 105 (1987). *Thwaites*, although dealing with Subchapter T allocations, also suggests interest income is allocated to non-member income.

Comment: These authors believe that a different result might be justified in the case of a reserve required to be maintained by a housing cooperative in order to obtain essential mortgage insurance, at least where such funds are beyond the corporation's control.[443]

[443] *See* Miller, *Section 277: Guardsmen or Marauder?* 10 J. Real Est. Tax'n 370, 374 (1983). Perhaps the concept and application of "effectively connected income," per §864(c)(2), regarding interest income and capital gain is a useful analogy.

d. Credits —

The IRS National Office has advised that §277(a) operates only to deny deductions and has no application to credits.[444]

[444] *PLR 7938010*.

e. Other Effects of §277(a) —

To achieve parallelism with other types of not-for-profit organizations, Congress in 1976 added the last sentence of §277(a),[445] which reads as follows:

[445] *See Rolling Rock Club v. United States*, 785 F.2d 93 (3d Cir. 1986), which also suggests that the income's being taxable to two different corporations is appropriate because, absent taxation of constructive dividends due to "enhanced services," there is no tax at the shareholder level.

> The deductions provided by sections 243 and 245 (relating to dividends received by corporations) shall not be allowed to any organization to which this section applies for the taxable year.

3. Subchapter T Applicability to Housing Corporations —

Subchapter T is discussed extensively in 744 T.M., *Taxation of Cooperatives and Their Patrons,* dedicated solely to Subchapter T, and it is not our intention to repeat those discussions in this Portfolio. We do discuss the consequences of applying Subchapter T to cooperative housing corporations in those limited situations already analyzed by the courts (specifically the application of §277), but see 744 T.M., *Taxation of Cooperatives and Their Patrons,* for greater analysis.[446]

[446] We highlight the possible application of patronage dividends to certain capital events below, but defer to 744 T.M., *Taxation of Cooperatives and Their Patrons,* for a more detailed analysis.

As discussed in the introduction to this chapter, under the *Buckeye* decision a corporation subject to Subchapter T is not subject to §277. The Tax Court held — most notably in the *Trump Village* case[447] and the *Thwaites* case[448] — that Subchapter T did apply to every housing cooperative that qualified as a "cooperative housing corporation" under §216.[449] Ultimately, the IRS went along. Those two cases and the IRS's reaction to each are discussed below. The cases further suggest that Subchapter T will apply to a housing corporation even in a year it fails to qualify under §216 so long as it retains the three Subchapter T attributes discussed below.[450]

[447] *Trump Village Section 3, Inc. v. Commissioner*, T.C. Memo 1995-281, which is discussed at VIII.A.3.a., below.

[448] *Thwaites Terrace House Owners Corp. v. Commissioner*, T.C. Memo 1996-406, which is discussed at VIII.A.3.b., below.

[449] Other Tax Court cases have also held or assumed that then "cooperative housing corporations" were within Sub T. *Concord Village, Inc. v. Commissioner*, 65 T.C. 142 (1975), *appeal dism'd* (9th Cir. 1977); *Park Place, Inc. v. Commissioner*, 57 T.C. 767 (1972). The entire discussion of the point in *Park Place* was as follows: "We disagree with the Commissioner's assertion that [Sub T] does not apply. Part I of that subchapter applies to the taxable year of any corporation operating on a cooperative basis after Dec. 31, 1962 and that necessarily includes a section 216 cooperative housing corporation." *Cf. Lake Forest, Inc. v. Commissioner*, T.C. Memo 1963-39, *appeal dism'd* (4th Cir. 1964). In 1975 the Ways and Means Committee stated its view that "a cooperative housing corporation is . . . taxed under the existing rules established by the courts . . ., the Internal Revenue Service, and by Subchapter T of the Code." H.R. Rep. No. 658, 94th Cong., 1st Sess. 329 n. 6 (1975)). It is interesting to note that at one time the IRS's Chief Counsel was of the opinion that "housing cooperatives could easily qualify for taxation under Subchapter T." GCM 34613 (Sept. 16, 1971). See also *PLR 7408193090D*, which assumed that a housing cooperative could be "operating on a cooperative basis." *But cf.* GCM 34413 (Jan. 29, 1971). *See also* Rev. Rul. 75-371 ("a condominium management corporation may operate in such a manner as to qualify for the benefits of Subchapter T").

[450] In the event §277 also applies to a housing corporation that fails to qualify under §216 for a given year, qualification under Subchapter T would make that moot. Rev. Rul. 90-36 (discussed above) (pre-*Trump Village* and *Thwaites*) provides that basic ownership rights in a housing cooperative is all that is needed to apply §277. The other §216 requirements, such as one class of stock and the 80% income or square foot tests, are not mentioned.

a. Trump Village —

In the course of arriving at its decision in *Trump Village*,[451] which was issued in 1995, the Tax Court stated the following:

[451] *Trump Village Section 3, Inc. v. Commissioner*, T.C. Memo 1995-281. The decision is discussed in Miller, *Tax Court Holds Section 277 Inapplicable to Housing Co-ops That Follow* Rochdale *Principles; Narrowness of Approach Troubling to Others,* 22 J. Real Est. Tax'n 152 (1996).

> Neither subchapter T nor the regulations promulgated thereunder define the phrase "operating on a cooperative basis" as used in section 1381(a)(2). In *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965), we surveyed the history and characteristics of cooperative associations and identified the following three guiding principles [sometimes referred to as the "Rochdale principles"] which form the core of economic cooperative theory:
>
> (1) Subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and the allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (*i.e.,* the excess of the operating revenues over the costs incurred in generating those revenues) in proportion to the worker-members' active participation in the cooperative endeavor.

The court then considered whether or not the petitioner housing cooperative complied with those three "guiding

principles," and concluded that it did. There was subordination of capital, said the court, because the shareholder-lessees had control "by reason of their position as *tenants,*"[452] because 15 of the corporation's 16 directors were required to be residents nominated by "not less than fifty stockholders residing in the corporation premises representing no less than fifty apartments," because current and liquidating dividends to the corporation's shareholders were limited to such amounts as were permitted by a certain statute, because no shareholder was legally permitted to sell their stock for more than they paid for it (including capital contributions), and because no shareholder was legally permitted to encumber their stock. There was democratic control, said the court, because each of the corporation's shareholders had only one vote regardless of the number of shares they owned. There was the necessary "vesting in . . . the worker-members," said the court, because the corporation was under its documents "required to take an operating deficit or surplus into account in setting future budgets and carrying charges." The court held that rebates of surpluses to the same tenants who paid in the money was unnecessary, so long as those surpluses were "disbursed to petitioner's shareholder-tenants in the form of reduced carrying charges" in the future.

[452] Emphasis added. The court did not make clear how it concluded that it was as tenants as opposed to being as shareholders.

b. Thwaites —

The Trump Village housing cooperative was a limited-equity housing cooperative,[453] and the IRS took the position that it was for that reason that it had been held to be within Sub T, asserting that there were still "cooperative housing corporations that do not qualify as subchapter T cooperatives."[454]

[453] *See* II.A.3., above.

[454] *Trump Village Section 3, Inc. v. Commissioner*, T.C. Memo 1995-281.

That proposition was rejected by the Tax Court the following year in the *Thwaites* case,[455] in which the court set forth two independent grounds for reaching the conclusion that Sub T applied to every cooperative within §216 as it then stood.

[455] *Thwaites Terrace House Owners Corp. v. Commissioner*, T.C. Memo 1996-406. The decision is discussed in Miller, *All Section 216 Co-Ops Held Free of Section 277 but Subject to Subchapter T Deduction Limits,* 24 J. Real Est. Tax'n 227 (1996).

The court's first ground was that it had already ruled on the question. Its opinion with reference to that ground could hardly have been simpler:

> In *Park Place, Inc. v. Commissioner*, 57 T.C. 767 (1972), we held that the taxpayer was a cooperative under subchapter T because it was a section 216 cooperative housing corporation. . . . The parties have stipulated that petitioner is a section 216 cooperative housing corporation. Thus, . . . petitioner is subject to the provisions of subchapter T.

There was one wrinkle that the court had to iron out, which it did, with admirable efficiency, as follows:

> Respondent contends that the fact that we applied the *Puget Sound* factors in *Trump Village* . . . shows that *Park Place* does not establish that section 216 cooperative housing corporations are subject to subchapter T and that we should apply the *Puget Sound* factors to decide whether a section 216 cooperative housing corporation operates on a cooperative basis for purposes of subchapter T. We disagree.
>
> There is no indication that the parties in *Trump Village* asked the Court to consider (or that the Court did

consider) whether *Park Place* establishes that a section 216 cooperative housing corporation operates on a cooperative basis for purposes of section 1381.[456] Thus, *Trump Village* does not bar our reliance on *Park Place*.

[456] One may speculate that the parties were reluctant to rely on *Park Place*, due to the fact that the Tax Court's opinion in that case made clear that the court did not understand the basic nature of a housing cooperative.

Having thus decided that no examination of the three special characteristics was necessary, the court nevertheless proceeded to examine them. However, the Commissioner fared no better here:

Respondent argues that petitioner does not meet the *Puget Sound* factors and thus does not operate on a cooperative basis. We disagree. First, petitioner meets the subordination of capital factor because its tenant-shareholders and patrons are identical and petitioner operated for the benefit of its patrons. Second, petitioner is democratically controlled by its tenant-stockholders. The fact that petitioner's shareholders may vote by proxy is akin to voting by absentee ballot. Also, the fact that petitioner's shareholders have one vote for each share they own (instead of one vote per shareholder) and that they own shares based on the relative sizes of their respective dwelling units is not contrary to democratic principles. The ownership percentage of shareholders of a housing cooperative is not only a measure of their investment, it is also a measure of their relative "patronage" of the housing cooperative. Third, petitioners did not fail to allocate profits to its members; in fact, it operated at a loss in the years at issue. We conclude that petitioner is a cooperative under the three factors . . . and that petitioner operates on a cooperative basis under section 1381(a)(2).[457]

[457] After the *Thwaites* decision appeared, five decisions of the Tax Appeals Division of the New York State Department of Taxation and Finance relied on it in ruling whether the taxpayer before it, which in each case had been conceded or held to be a "cooperative housing corporation" as defined by then §216(b)(1), was under Sub T and therefore not subject to §277(a). *Matter of 330 Third Ave. Owners' Corp., DTA No. 809615*, TSB-D 98(4)C (Tax Apps. Trib. Mar. 26, 1998), *aff'g on other grounds* (ALJ Sept. 26, 1996); *Matter of Ocean Terrace Owners, Inc., DTA No. 809719*, TSB-D-98(3)C (Tax Apps. Trib. Mar. 26, 1998), *rev'g* (ALJ Sept. 12, 1996); *Matter of 52 Riverside Drive Owners Corp., DTA No. 811136* (ALJ June 4, 1998); *Matter of 300 Owners Corp., DTA 808709* (ALJ Oct. 16, 1997); *Matter of 113-14 Owners Corp., DTA No. 810205* (May 1, 1997). It is interesting that not one of them relied on *Thwaites*' first holding (i.e., that all "cooperative housing corporations" under then §216(b)(1) were within Sub T). Rather, each proceeded to a consideration of whether the taxpayer had sufficiently established compliance with the three *Puget Sound* factors. In fact, in two of the cases, a demonstrated-to-be "cooperative housing corporation" as defined in then §216(b)(1) was held to be outside of Sub T due to a failure to allege or establish such compliance. *Matter of 52 Riverside Drive Owners Corp.,* above; *Matter of 113–14 Owners Corp.,* above.

4. Subchapter T Limits on Deductions

a. In General —

The taxpayer in *Thwaites* won the battle that it was a Subchapter T corporation but lost the war with respect to its actual dollar claim that its deductions from shareholder/patron losses could be used against its interest income. Like §277, Subchapter T has a doctrine, although judicially created, that prevents a cooperative with "nonpatronage-sourced income" from avoiding taxation thereon by setting prices to its cooperators low enough so

that overall it would show no or a greatly reduced profit. The courts developed the rule (comparable to that embodied in §277) that a cooperative "simply may not use patronage losses to reduce its tax liability on nonpatronage-sourced income."[458]

[458] *Farm Serv. Coop. v. Commissioner*, 619 F.2d 718, 727–28 (8th Cir. 1980). The wisdom of the rule has been recognized. *See, e.g.,* S. Rep. No. 146, 99th Cong., 1st Sess., 377 (1985) ("[T]he Committee approves the result in *Farm Service* . . ., which held that a non-exempt cooperative could not offset patronage losses against nonpatronage earnings."). Two years later, the rule was embraced by the Tax Court. See *Certified Grocers of California, Ltd v. Commissioner*, 88 T.C. 238 (1987).

The following passage from a field attorney advice issued in 2013 is instructive:

> For Federal income tax purposes, a nonexempt cooperative is a hybrid entity. As respects patronage-sourced income, it is taxed like a passthrough entity with its income being taxed only once, usually to the patron, but as to nonpatronage-sourced income, it is taxed like a C corporation with its income being fully taxable to the cooperative, and, if paid out to patrons, to the patrons as well. * * * The prohibition against using patronage-sourced losses to offset nonpatronage-sourced income is not explicitly set out in the Code. Rather, it is inherent in the structure of Subchapter T and is necessary to preserve the "statutory distinction" between the tax treatments of the two types of income, *i.e.,* that patronage-sourced income is generally not taxed at the cooperative level whereas nonpatronage-sourced income is. *Farm Service Cooperative*, 619 F.2d at 727. If a nonexempt cooperative could use a patronage-sourced loss to reduce its nonpatronage-sourced income, the effect would be to extend the tax benefit intended for patronage-sourced income to nonpatronage-sourced income. That is, nonpatronage-sourced income could be shielded from taxation at the cooperative level.[459]

[459] FAA 20132701F (May 16, 2013).

Obviously, then, what income is considered "nonpatronage-sourced income" is a matter of great importance.

b. Subchapter T as Applicable to Commercial Cooperative Housing Rental Income —

In *Thwaites*, the court determined that interest earned from non-required money managed funds raised from shareholders was not directly related to its patronage focused business of providing housing services. *Trump Village*, by contrast, did have its various funds in required escrow accounts.[460] But the exact reasoning for permitting the interest income in *Trump Village* to be treated as patronage sourced does not exist as the court did not consider the patronage (deductible) vs. non-patronage (not deductible) and the parties did not raise it.

[460] To include mortgage, development, operating and administration funds required either by the lender or State law to reflect its obligations as a limited profit housing corporation under New York's Mitchell-Lama Law.

No court or other authority has considered the question of whether commercial rental income from non-shareholders gives rise to patronage income. To answer that we must review certain aspects of Subchapter T patronage vs. non-patronage income provisions.

As noted by a thoughtful commentator, "[f]or taxable cooperatives, the distinction between patronage and nonpatronage-sourced income is critical."[461] The Code provides that, in order to be the source of a "patronage dividend," the amount in question must be both (a) "paid on the basis of quantity or value of business *done with or for* such patron," and (b) "determined by reference to the net earnings of the organization from business done with or for its patrons."[462] A commercial lessee is not a shareholder patron so in order for its rental income to be

patronage income, it must, in the words of the statute, constitute income done *for* the patrons.

[461] Reynolds, *Patronage-Sourced Income: An Expanding Universe,* 58 Tax Law. 479 (2005) (footnotes omitted). As Mr. Reynolds points out, there are two reasons that the distinction is so important: "first, a taxable cooperative is permitted to deduct (or to exclude from income) the patronage dividends that it allocates to its patrons (which dividends, by definition, are limited to the cooperative's patronage-sourced income); second, a taxable cooperative is prohibited from offsetting its patronage-sourced losses against its nonpatronage-sourced income." We focus here on the second reason and mention in passing herein the first reason.

[462] §1388(a)(1), §1388(a)(3).

The meaning of the phrase "business done for" patrons has been left largely to the courts, a full analysis of which can be found in 744 T.M., *Taxation of Cooperatives and Their Patrons.*

In the typical cooperative housing corporation, the residential units are part of a single apartment building that may be any size, but typically run four or more floors, with perhaps an average height of 20 floors.[463] First floor space is often unsuited commercially for residential purposes, or if suited, may be legally impermissible due to zoning restrictions or building code limitations. Even if all rentable space is used for commercial purposes, the first floor will have common area space such as lobby area, mailroom and perhaps the superintendent office. Thus, commercial rental space may, in the estimated four- to 20-floor building size, be something less than 5% to 25% of total rental space.[464] So what is the cooperative and its Board to do? Turn its back on commercial income to avoid the nonpatronage tax allocation or nonpatronage dividend concern?[465]

[463] The cooperative may own several residential buildings or be structured as townhouses or otherwise structured differently than the single residential apartment building model. The single building model is by far the most prevalent structure in the experience of these authors, and our initial view is that the tax analysis should be the same.

[464] Perhaps a little more if the cooperative also leases commercial space outside the building for signs or rooftop commercial antennas.

[465] *See* Reynolds, *Patronage-Sourced Income: An Expanding Universe,* 58 Tax Law. 479 (2005)

In a leading case from the Federal Circuit as to what distinguishes "patronage income" from "nonpatronage income, " a rapidly growing title-taking buying cooperative whose cooperators were the owners of hardware stores built a warehouse to hold, until needed by its cooperators, large amounts of merchandise bulk-purchased by it. The warehouse was larger than necessary for the cooperative's current needs, and it rented out not-yet-needed floors to third parties having nothing whatsoever to do with the cooperative's operations. The issue here was whether the net income from such rentals constituted "patronage income."[466] Overturning the decision of the court below, the Federal Circuit said:

[466] *Cotter & Co. v. United States*, 765 F.2d 1102 (Fed. Cir. 1985).

> [T]he Claims Court held that the transactions were not business done for patrons. . . . * * *
>
> Considering the case presented in light of the proper focus, we conclude that the income at issue was earned from business done for patrons.[467]

[467] Note the heavy reliance on the word "for." One commentator stated the present

> situation quite clearly: “Because income received not only ‘from’ patrons but also ‘for’ patrons qualifies as patronage-sourced income, it is not essential that the payer of the income be a patron of the cooperative in order for the income to qualify as patronage-sourced income.” Reynolds, *Patronage-Sourced Income: An Expanding Universe,* 58 Tax Law. 479, 485 (2005). By an interesting coincidence, the very same page contains a quotation from the Senate floor colloquy at the time that Subchapter T was being considered, which statement indicates the true intent of the word “for”: “Business done is not necessarily limited to products sold to or purchased from patrons. Business done also includes services performed for patrons, as well.” 108 Cong. Rec. 18,322 (1962).

Its explanation was as follows:

> The rental income earned through the leasing out of temporarily excess space is . . . patronage sourced. The stipulated facts clearly show that renting temporarily excess space was only a minor component of taxpayer's plan for making certain that Cotter had sufficient warehouse and manufacturing space. Architects do not as yet provide warehouses with accordion pleated walls that may be expanded or contracted in strict conformity to the owner's needs. Indeed, the Claims Court concluded that “the purchase or construction of warehouse facilities larger than necessary for its present needs facilitated the operation of its growing business.” *Cotter*, 6 Cl. Ct. at 231. The court then erred by considering the short-term rental of temporarily unneeded space apart from the facts that Cotter had to maintain excess space, the determination of required capacity is inexact, and the space was rented only as part of Cotter's plan to expand its space over its then-existing needs. It is clear from the undisputed facts that Cotter did not go into the warehouse rental business, seeking to enhance corporate profits while hiding behind its label as a cooperative.

The appellate court responded as follows to the notion that it was giving the “for” word too much force:

> We agree with the Claims Court that Congress did not intend the term “with or for patrons” to be “of unlimited scope, [so that] *all* income produced by cooperatives that is passed through to patrons would be, in essence, income obtained *for* patrons, and would, therefore, be considered patronage sourced.” *Cotter*, 6 Cl. Ct. at 227. A cooperative cannot merely “clothe its shareholders as patrons and its corporate dividends as patronage payments” and retain the benefits of Subchapter T. *Mississippi Valley*, 408 F.2d at 835. *But Subchapter T was also not enacted to require that a cooperative acting for its patrons function in an economically unreasonable manner or penalize it for acting reasonably.* [emphasis added] Considering the income-generating transaction in its relation to all the activity undertaken to fulfill a cooperative function will allow courts to distinguish from cooperative activity transactions which merely enhance overall profitability in a manner incidental to cooperative function. Such activity is not to receive the benefits of Subchapter T, but other activity, which does directly relate to cooperative function when considered in its actual business environment, cannot properly be considered outside “business done with or for patrons.” Cotter's transactions here were not merely to gain incidental profits; they resulted from activities integrally intertwined with the cooperative's functions. The earnings Cotter in this case produced and passed through to its members are patronage dividends.

Comment: The court placed great emphasis on the undoubted fact that it would have been economically foolish for the cooperative to leave those floors vacant. Similarly, the cooperative housing corporation would be acting foolish to turn its back on excess space.[468] In some ways, the cooperative housing corporation can make a stronger case than the taxpayer in *Cotter* for patronage rental treatment. Unlike the taxpayer in *Cotter*, cooperative housing corporations are in the rental service business. For Cotter, such rental activity was a byproduct of its hardware purchasing activities, to include warehousing, and not directly related. While the *Cotter* court indicated that the warehouse rental income was temporary, there is no indication that the taxpayer ever used the excess space for its own warehousing.[469] To date, these authors are not aware of any IRS audit of such cooperative commercial rental

income in light of, we believe, the *Trump Village*, *Thwaites*, and *Cotter* decisions.[470]

[468] Keep in mind, the "excess" space of the apartment building is not some subsequent add on to the building, but rather is an integral part of the structure. Remove the uneconomical first floor and the building will collapse.

[469] A cooperative could equally argue, consistent with Cotter, that its commercial rental income is just temporary until it converts such space (if allowable) into residential space in which it issues shares to a tenant-stockholder (who would likely be the commercial tenant).

[470] See also the decision of the Tax Court in Illinois Grain Corporation 87 T.C. 435, (1986) in support. (River barge third-party rental income was patronage sourced.)

B. Section 216(e) — Cooperative-to-Condominium Conversion

1. Introduction —

A corporation generally must recognize gain on the distribution of appreciated property to a shareholder to the extent the fair market value of the property exceeds its adjusted basis in the hands of the corporation.[471] Section 216(e) provides an exception to this rule where a cooperative complies with its detailed provisions and converts its fee ownership in the residential units to a condominium regime, distributing such condominium units to shareholders either in complete liquidation or in redemption of their stock interests. This special provision, applicable only to cooperative housing corporations, is the third major way tax provisions applicable to such corporations diverge from the provisions under Subchapter C applicable to the garden variety corporation, and is discussed below.[472]

[471] §336(a) (distributions in liquidation), §311(b) (non-liquidating distributions).

[472] Might the §1382(b) patronage dividend deduction, a Subchapter T provision, apply apart from §216(e) to eliminate the gain in whole or in part?

Following is a brief description of the typical steps in a co-op-to-condo real estate conversion.[473]

[473] The steps in some particular cooperative-to-condominium conversions and, to some extent, the reasons therefor, are described in Rev. Rul. 85-132; PLR 200645001, PLR 200137032, PLR 9709009, PLR 9428006, PLR 9012003, PLR 8812049, PLR 8810034, PLR 8445010, PLR 8443055, and PLR 8443054. *See also* Miller, *Probable Income Tax Effects of New York City Cooperative-to-Condominium Conversion,* 24 Tax Mgmt. Real Est. J. 329 (2008).

1. The corporation records a condominium declaration that, inter alia, (i) makes each shareholder-lessee's apartment a condominium unit (the balance of the corporation's realty and some designated personalty thereupon becoming the common elements owned proportionately by the unit owners) and (ii) establishes a condominium association.

2. The corporation transfers to the condominium association all of its property other than the condominium units.

The corporation distributes the condominium units to its shareholders in exchange for their shares (the appurtenant possessory rights falling by the wayside because only a shareholder has such rights and/or because the lessor and the lessee have become the same person).

2. Possible Relief Under §216(e)

a. Introduction —

A total co-op-to-condo conversion entailed no significant income tax burden for the corporation until the Tax Reform Act of 1986 changed the taxation-on-liquidation rules for corporations generally, which change would of course apply to housing cooperatives unless such corporations could somehow be shown to be exempt from the operation of the rules of revised §336(a).[474] In 1987, a housing cooperative sought a private letter ruling declaring such an exemption, but the IRS ruled otherwise as a result of the changes regarding property distributions under the Tax Reform Act of 1986.[475]

[474] And in the case of individual redemptions for a condo unit, §311(b).

[475] PLR 8812049.

As part of the Technical and Miscellaneous Revenue Act of 1988, Congress added §216(e) to address the problem. As enacted it provided an elegant solution by excusing both the "cooperative housing corporation" from gain recognition when it distributed a "dwelling unit" to one of its shareholders in exchange for their shares, and also permitted non-taxable gain rollover to the shareholder upon receipt of the unit, but in both cases only if "such exchange qualifie[d] for nonrecognition of gain under section 1034(f)."[476]

[476] Pub. L. No. 100-647, §6282. It may be noted that §216(e) has always also prevented loss recognition.

Note: Section 216(e) is not a general exception to the rule on recognition of gain from distribution of appreciated property, or the proceeds of its sale, by a corporation generally. It only applied if there is a distribution of property and such property is a dwelling unit eligible for former §1034(f) shareholder relief. Thus, if the cooperative were to sell the building and distribute the proceeds to shareholders in liquidation, it would, absent any relief under Subchapter T, recognize the gain from sale and the shareholders would recognize their gains from the exchange.[477]

[477] Unlike a partnership that would pass through such gain to its partners so that only one level of tax applies. §701.

A number of issues arose under the 1988 version of §216(e), many of which were due to the inclusion of the exchange-must-qualify-under-§1034 requirement.[478] But those legal issues paled in comparison to the economic problem that arose when §1034 was repealed in 1997, at which time — as a "conforming amendment" — the concluding language in §216(e) was changed to "such dwelling unit is used as his principal residence (within the meaning of section 121)."[479]

[478] *See* Miller, *The General Utilities Repeal and Co-op to Condo Conversions,* 16 J. Real Est. Tax'n 265 (1989); Miller, *Congress Grants Co-ops Limited and Uncertain Relief from General Utilities Repeal,* 5 Tax Mgmt. Real Est. J. 15 (1989).

[479] Pub. L. No. 105-34, §312(d)(4).

Under the 1997 version, the shareholder no longer had §1034 rollover treatment and would be subject to tax on gain under the liquidation or redemption if gain exceeded $250,000/$500,000 under §121.[480] Congress failed to

include rollover provision when the §121 language was included, making the current version of §216(e) quite non-user friendly for many cooperatives.[481]

[480] The exchange of the shares of the cooperative for the condominium unit used as their principal residence would be eligible for such §121 treatment. PLR 200645001 (Ruling 7).

[481] Perhaps Congress was of the view that the $250,000/$500,000 exemption for gain on sale of a principal residence would eliminate tax for all but the most expensive homes. While perhaps true for values in 1997, today these authors are aware of cooperatives considering such conversions that are placing them on hold while other methods, such as the elective redemptions found in PLR 200645001, are considered.

b. Analysis of §216(e) —

Three issues — referred to as "the corporate-qualification issue," "the dwelling unit in exchange issue," and "the used-as-principal-residence issue" — are discussed below.

Preliminarily, though, it may be observed that, despite the genesis of §216(e), neither the congressional committee reports nor the provision itself makes any reference to cooperative-to-condominium conversions or even mentions any of the words "liquidation," "conversion," or "condominium."[482]

[482] *See* S. Rep. No. 76, 100th Cong., 1st Sess. 605 (1987); H.R. Rep. No. 1104, 100th Cong., 2d Sess. 241 (1988). *See also* H. Con. Res. No. 93 (1987) in PLR 200645001.

Because §216(e) refers, not to condominium units as such, but to "dwelling units" generically, the statute covers distributions of independently owned free-standing houses to be owned by the recipients outside the condominium format.

Also, a liquidation of the distributing corporation is not required. That allows for a variety of transactions. For example, where some shareholder-lessees desire a complete cooperative-to-condominium conversion, but others want to continue to own cooperative apartments, the corporation can create a condominium with each apartment contained in a separate condominium unit and do condominium-unit-for-shares exchanges in redemption with those of the shareholder-lessees who want to do that, thereafter operating the retained condominium units as a "cooperative housing corporation." Because there is no time element in §216(e), later exchanges can be made if and when circumstances change (for example, upon the death of a holdout shareholder-lessee). By such a means, a "creeping" full cooperative-to-condominium conversion may be achieved over time. Such a conversion was contemplated in the situation described in PLR 200645001.

(1) Potential Regulatory Limitations —

Congress passed the ball to the Treasury with respect to the potential for limiting the corporate gain recognition by beginning the subsection with the words "[e]xcept as provided in regulations." However, no regulations have been promulgated — or even proposed — as of this writing.

The legislative history does, however, provide some indication of what the legislators might have had in mind. The provision was added in the Senate, and both the Senate Finance Committee report on an earlier proposal along the same lines[483] and the Conference Committee report[484] included the following:

[483] Senate Budget Comm., 100th Cong., Reconciliation Submissions of the Instructed Committees Pursuant to the Concurrent Resolution on the Budget for Fiscal Year 1988, H. Cong. Res. 93, Rept. No. 100-76, at 605 (Comm. Print 1987).

[484] H.R. Rep. No. 1104, 100th Cong., 2d Sess. 241 (1988).

It is expected that the Treasury Department will prescribe regulations providing reporting or other procedures to assure that the intended relief [from corporate-level gain recognition[485]] is provided only in cases where the house or apartment is in fact used by the taxpayer[486] as his principal residence both before and after the distribution. Also, the Treasury Department may prescribe rules to assure that there is a full recapture of tax benefits (if any) that may have been claimed at the corporate level, to the extent the same benefits could not have been claimed by the shareholder if he had owned the house or apartment directly and used it as his principal residence.

[485] The supplied words clearly convey the intended meaning. The preceding sentence in the report stated unequivocally (emphasis supplied) that "no gain or loss is recognized *to a residential housing cooperative*" if the provision's conditions were satisfied, and it was then clear that the shareholder-lessee had to look to former §1034 for any relief to which they might be entitled. Moreover, the provision was virtually identical to an earlier proposal that the Senate Finance Committee had adopted and described as follows in its report under the heading "Relief From Recognition of Corporate Level Gain Involving Transfer of Residential Cooperative units [sic]":

> *Reasons for Change.* The committee believes that it is generally appropriate to provide relief *from corporate level gain recognition* in the case of a distribution of appreciated property to a shareholder of a cooperative housing association [sic] if the exchange of the shareholder's stock for such property would qualify for nonrecognition of gain under section 1034 of the Code.
>
> *Explanation of Provision.* The bill provides that, except as provided in regulations, no gain or loss shall be recognized *at the corporate level* on the distribution to a tenant shareholder of property in exchange for his stock to the extent the exchange qualifies for nonrecognition at the shareholder level under section 1034 of the Code.
>
> Sen. Rep. No. 76, 100th Cong., 1st Sess. 605 (1987) (emphasis supplied).

[486] The reference here obviously should have been to the shareholder rather than to "the taxpayer," but the slip is understandable if one keeps in mind that at the time corporate-level relief was available only to the extent that the shareholder-lessee qualified for relief under then §1034.

Note: The legislative history refers to the original 1988 version of the subsection when compliance with former §1034 was required.[487]

[487] *See* VIII.B.2.b.(4), below.

(2) The Corporate-Qualification Issue —

By its terms, §216(e) is unavailable to a housing cooperative that does not qualify as a "cooperative housing corporation" at the time of the subject distribution. Thus, care must be taken to ensure that the exchanges occur prior to any loss of qualification.

Because §216(e) refers only to "stockholder" — as opposed to "tenant-stockholder" — corporate-level relief does not depend on the exchanging shareholder having that status. So long as qualification is maintained — which does not require that all shareholder-lessees qualify as "tenant-stockholders" — it is now a matter of indifference to a corporation invoking §216(e) as to a particular exchange whether the counterparty shareholder is or is not so qualified.[488]

[488] Because former §1034 applied only to exchanges in which the shareholder qualified as a "tenant-stockholder," that is a very important respect in which the current version of §216(e) differs from the pre-1997 version.

(3) The Dwelling-Unit-in-Exchange Issue —

Because §216(e) applies only to distributions of "dwelling units," distributed "in exchange" forstock in the cooperative, the scope of the terms is a matter of overriding importance. Unfortunately, the statute contains no definition, and there are no implementing regulations. The nature of the problem is best presented by considering the not-too-improbable hypothetical situation in which a "cooperative housing corporation" owns all of the following:

- A building containing residential apartments, professional offices not constituting apartments but treated as eligible spaces under the rules embodied in Rev. Rul. 90-35,[489] repossessed foreclosed residential units, a large supermarket space and other purely commercial spaces, lobbies, meeting rooms and other common areas, storage spaces, a boiler room and other spaces used to operate the building, elevators, building systems, and a blank wall rented out for advertising purposes.

[489] *See* IV.E.7.b.(3), above.

- The land on which the building is situated.
- A parking garage on an adjoining parcel.
- Tennis courts and a pool on an adjoining parcel.
- A vacant lot held purely for investment purposes.
- Building supplies, snowblowers, maintenance tools, fuel oil, lobby furniture and office equipment.
- Cash operating, replacement and contingency reserves in much more than the usual amounts.
- A portfolio of securities held purely for investment.

Which of the above — and/or how much of each — can safely be included in a "dwelling unit"? Clearly, a "dwelling unit" can be a condominium unit (A) containing only an ordinary residential apartment and (B) having appurtenant to it interests in (i) common elements to the extent necessarily auxiliary thereto (e.g., a lobby servicing only such apartments) and (ii) a condominium association owning only the usual items (e.g., building supplies and an appropriate amount of cash). Otherwise, §216(e) would be essentially meaningless. What about such items as the supermarket space that would thereafter produce income belonging directly to the condominium unit owners?[490] Vacant land held for investment would likely not qualify as it is not an integral part of the land and building that make up the residential units and likely could be sold separately without affecting the value or use of the cooperative unit by the shareholder. How about professional space that does or does not constitute common elements? Repossessed units distributed as common elements would not

qualify.[491]

[490] In our examination of Subchapter T patronage vs. non-patronage income in this chapter we conclude that a strong argument can be made under the *Cotter* decision that the supermarket and other retail space held as common elements of the building by each shareholder is so intertwined with the residential units as to be considered part of the residential space for purposes of determining patronage/shareholder income. It should follow that if the shareholder resides in the unit as their principal residence, the retail common space ought to qualify under §216(e). On the other hand, a residential unit even without such common element retail space will fail to qualify under §216(e) if the owner does not reside in the premises as their principal residence. The fact that the owner will recognize their share of the rental income in the former, if anything, supports treatment as a qualifying principal residence property as no income is lost by the FISC (depending on whether such retail income was sheltered by shareholder losses, the FISC may be enhanced). Alternatively, can the coop get the same result under the patronage dividend rules applicable to the cooperative housing corporation?

[491] PLR 9709009. A formerly owned residential unit distributed as a common element to all shareholders that was both livable and lived in is a discreet dwelling space but not currently inhabitable by its owner (it may be vacant or rented) and would not qualify.

(4) The Used-as-Principal-Residence Issue —

One of the requirements of §216(e) is that the distributed dwelling unit must be "used as [the distributee's] principal residence (within the meaning of section 121)."

Unlike the 1988 version of §216(e), which conditioned corporate-level relief on shareholder-level relief being available under former §1034, the present version requires only that the dwelling unit be used as a §121 "principal residence," and that is a factual inquiry, which inquiry is very different from the inquiry whether the distribute-shareholder-lessee is entitled to relief under §121. There are many reasons that such relief may be unavailable even where the disposed-of dwelling unit is clearly being used as the distributee's §121 "principal residence" — as, for example, where the dwelling unit was sold, as a matter of free choice, after it was owned for less than two years — but the distributing corporation no longer cares about almost all of such things.

On the other hand, the distributing corporation may not be entitled to §216(e) relief despite the distributee-shareholder's gain being excludible under §121. Such a situation would exist, for example, where the distributee-shareholder had moved out well before the exchange but still satisfied the two-out-of-five-year requirements of §121.

The distributing corporation may also have other "principal residence" problems under §216(e). As noted, use as a §121 "principal residence" is a fact-based determination, and the critical information may not be known to the corporation.

Another question is when the used-as-principal-residence test is to be applied.

(a) Seller-Side Cooperative-Unit-to-Condominium-Unit Conversion —

In PLR 200645001, the IRS favorably ruled on "creeping liquidation" that was put in place to allow shareholders, who could establish to the satisfaction of the Board that their units were principal residences, to exchange their cooperative shares in redemption for the distribution of their residential unit in condominium form. While such exchange was determined to be non-taxable to the corporation under

§216(e), it would be taxable to such shareholders under §121 whose gain exceeded the statutory limits of $250,000/$500,000 and fully taxable to those shareholders who were otherwise ineligible for the §121 exemption. Presumably, either of such shareholders would wait to make the exchange until they had a buyer for their condominium unit.[492]

[492] The redemption would step up the basis in their shares to fair market value, at which point a sale could be made without recognition of further gain. §302. Had they converted earlier prior to having a buyer lined up, they would recognize gain without the further tax-free receipt of cash from a sale to pay their tax.

Would such sale so close to the conversion exchange create an issue under the 1988 version of the legislative history but not an issue under the current 1997 version? The earlier version suggests that Congress believed that such relief should be available "only in cases where the house or apartment is in fact used by the [distributee] as his principal residence both before and after the distribution."[493] But that is not terribly controversial. The 1988 version was dependent on qualification under former §1034 which required a two-year lookback and lookforward to acquire the replacement residence and effectively limited such exchanges to no more than one every two years.[494] Indeed, under the 1988 version, the IRS stated in two separate PLRs that in order for the corporation to be eligible for §216(e) exemption, the shareholder must have held the unit for a period of at least two years prior to the distribution of the deed as their principal residence while it was in cooperative form, and will continue to hold the unit after receipt of the deed as their principal residence for two more years.[495]

[493] *See* VIII.B.2.b.(1), above.

[494] Former §1034(d)(1).

[495] PLR 9428006, PLR 9709009.

The 1997 version of §216(e) does not contain any requirement for shareholder qualification under former §1034 or current §121 and, correspondingly, would not impose any pre or post holding time limit. All that is required is that the dwelling unit serve as the shareholder's principal residence at the time of distribution, a fact-based test under §121 and Reg. §1.121-1(b).[496] Assuming the cooperative unit was the shareholder's principal residence, to the exclusion of any other residence they may own, upon conversion, the same space and use would not change and they should also be holding the resultant condo unit as her principal residence. A sale shortly thereafter, even if planned, should not change that result.[497]

[496] PLR 200645001 (ruling 3). The regulations contain no time period needed to obtain principal residence status. Rather they tend to look at factors similar, in these authors view, to establishing domicile which can arise almost immediately upon moving into a new home without retaining one's former home (whether owned or rented) as typically would be the case in most home purchases. Reg. §1.121-1(b) (The regulations have an implied default rule that a residence is a principal residence if it is the taxpayer's only residence). See 594 T.M., *Tax Implications of Homeownership,* for a detailed analysis of principal residence.

[497] Of course, if they bought another residence and moved in prior to relinquishing the condominium, the results may differ. But in that scenario, the cooperative/condo unit may not have been their principal residence.

(b) Buyer-Side Cooperative-Unit-to-Condominium-Unit Conversion —

Depending on the negotiating strengths of the parties, the seller of a cooperative unit may not want the hassle of converting their unit to a condominium and risking phantom income on the redemption should a sale fall through. Seller's view may be that if the buyer only wants to acquire their cooperative unit in condominium form, let the buyer buy the cooperative shares and make the redemption exercise under the corporation's plan themself. There is some appeal to employing the buyer redemption exercise. The buyer would not have the personal direct tax risk of gain recognition on the redemption as their cost basis would be equal to the fair market value for the unit, thus no gain.[498] As we discussed on the seller side redemption above, the regulations do not impose a holding period for the new home that would prohibit a finding of principal residence status upon the purchase of a cooperative or condominium unit. Consistent with, and in support of this treatment, the personal qualified home interest deduction for acquisition indebtedness of a qualified residence defines the qualified residence as the principal residence within the meaning of §121, with the same no holding time period employed by §216(e).[499]

[498] §302.

[499] §163(h)(4)(A)(i)(I). Indeed, the taxpayer can deduct the interest as soon as the mortgage loan is effective, as every new homeowner is aware.

C. Certain Subchapter C-Related Issues

This chapter has so far analyzed the three significant tax law provisions applicable to a cooperative housing corporation not typically applicable to a garden variety C corporation: §277, Subchapter T, and §216(e). In its capacity as a C corporation, several other matters are worth noting.

1. Amounts Refunded to Shareholders —

Assuming that payments by its shareholders to a housing cooperative may generate taxable income (i.e., they are not held in a fiduciary capacity and are not capital contributions or otherwise excludible) and assuming further that the payments amount to more than the corporation needs, can the corporation avoid having income by returning the excess to its shareholders? The answer seems to be a qualified yes.

a. Actual Return in Same Year —

The IRS has ruled that any excess refunded within the same year will in effect be treated as if it had never been paid.[500]

[500] Rev. Rul. 56-225. This may look to the casual observer as nothing more than the use of the “recission doctrine.” There is no apparent reason that this result should depend upon the corporation's qualifying as a “cooperative housing corporation” under §216.

b. Credit Against Later Charges —

The scope of the final sentence of Rev. Rul. 56-225, quoted above, is not entirely clear. Plainly, exclusion from

income is not justified by the mere fact that there will be an indirect benefit to the shareholder resulting from the fact that the corporation ends the year with surplus funds, thus reducing the amount that will have to be collected in future years. But what if the corporation in addition sets up a specific credit account for each over-contributing shareholder or apartment?

There might well be a practical effect, since such a credit balance would very likely be an adjustment in the event of a sale, whereas a mere cash surplus in the hands of the corporation would tend not to be reflected in the transaction (even though, theoretically, it would increase the purchase price).

Despite that difference, the referred-to language of the ruling, stating that there is no exclusion absent an actual return within the same year, would seem to cover a specific credit situation as well. The matter may hardly be regarded as being settled, however, for two different reasons. First, the Tax Court has explicitly rejected the return-within-the-same-year requirement, holding that amounts are properly excludible from income where book credits are made within the following 12 months pursuant to a pre-existing obligation to do so and reserving the question of whether a credit given at even a later date might be sufficient.[501] Also, in the fully analogous condominium area the IRS has ruled that, at least where the unit owners actually voted on the matter, it is enough if the amount of the excess is to be applied against amounts due the following year. “[T]he excess assessments for the taxable year over and above the actual expenses paid or incurred for the purpose described above are not taxable income to the corporation,” said the IRS of such a situation, “since such excess, in effect, has been returned to the stockholder owners.”[502]

[501] *Lake Forest, Inc. v. Commissioner*, T.C. Memo 1963-39, *appeal dism'd* (4th Cir. 1964). The force of this decision may have been diminished by later, but questionable, decisions. *See Park Place, Inc. v. Commissioner*, 57 T.C. 767 (1972); *Concord Village, Inc. v. Commissioner*, 65 T.C. 142 (1975), *appeal dism'd* (9th Cir. 1977). Those cases seem to impose in some situations a limit of 8 1/2 months into the following year, on the theory that such refunds must qualify as “patronage dividends.” *See* XIV.A.2., below.

[502] Rev. Rul. 70-604. Although it is not entirely clear, it would appear that it is not necessary that the decision be made before the end of the taxable year, inasmuch as the amount of the excess would not be known before then. *Cf. Mission Heights Homeowners Ass'n v. United States*, 96-2 USTC ¶ 50,489 (S.D. Cal. 1996) (stating that “an association may, pursuant to the administrative procedures enumerated in Revenue Ruling 70-604, refund excess assessments to its members or apply such excess amounts to the members' subsequent year's assessments, thereby removing such amounts from income,” but holding that the plaintiff homeowners association “failed to follow the procedures identified in Revenue Ruling 70-604 so that it could exclude its excess assessments from income”). An annual decision by the unit-owners would appear to be required. See TAM 9539001, which takes the following narrow view of the revenue ruling. “[T]he benefits of Rev. Rul. 70-604,” says the TAM, “are limited to a taxpayer where the factual pattern in question is substantially similar to the facts stated in the revenue ruling. Rev. Rul. 70-604 obviously was published as a rule of practical convenience for both taxpayers and the Service but it essentially constitutes an administrative exception to the inclusion of income under §61 of the Code and, as such, must be strictly construed.” It is hard to argue with the TAM's view. The rule of Rev. Rul. 70-604, while perhaps defensible as a rule of convenience, simply cannot be regarded as doctrinally sound; it is a basic income-tax principle that, except as provided in §467 and the regulations thereunder, prepaid amounts of this type are income to the payee when received, regardless of the taxpayer's accounting method, even if the payments are attributable to a future period. *See.* Reg. §1.61-8(b). *See also* IRS Info Letter 2016-0066 (June 29, 2016) (“Rev. Rul. 70-604 does not provide that a condominium management corporation may exclude from income amounts that it accumulates in a

working capital reserve."); IRS Info Letter 2009-0233 (Nov. 2, 2009) ("Rev. Rul. 70-604 does not provide that a condominium management corporation may avoid recognizing taxable income attributable to excess assessments by accumulating the excess amount in a working capital reserve."). In IRS Info Letter 2013-0013 (Dec. 17, 2012), the public was advised that the quoted statement "continues to reflect the Service's position." Also, the IRS is known to have felt that Rev. Rul. 70-604 would not be applicable where the condominium proposed to treat the excess amounts as capital contributions (rather than gross income) in the following year. *See also* Vander Jagt and Snyder, *Suggestions for the 1996 Business Plan Regarding Homeowners Associations,* 15 Tax Mgmt. Wkly. Rpt. 267 (Feb. 19, 1996); Porter, *Is Rev. Rul. 70-604 Still Alive,* The Ledger Quarterly (Winter 1993), at 6; FSA CC:TL-N-2114-92; FSA CC:TL-N-6262-92; IRS Info Letter 2001-0176 (July 9, 2001). These authors have been advised that, as recently as September 2014, the responsible IRS officials reiterated that Rev. Rul. 70-604 is not to be extended, but must be narrowly interpreted.

Comment: There would seem to be no reason that excess maintenance charges collected by a housing cooperative should be treated differently from excess assessments collected by a condominium management corporation. If, in the latter case, "such excess, in effect, has been returned," it is difficult to see why it has not in effect been returned in the former case as well.[503] Also, there seems to be no reason for a limitation to the following year only.[504] Until this matter is clarified, if exclusion of returned amounts is desired it would seem prudent to see to it that they are returned in cash within the same taxable year.

[503] See GCM 34613 (Sept. 16, 1971), which states as follows: "[O]ne way a cooperative housing corporation can avoid taxation of excess assessments is to use the procedure set forth in Rev. Rul. 70-604. Although the ruling deals with a condominium, it is our opinion that the procedure is equally applicable to a housing cooperative."

[504] The IRS appears to have retreated from the "following year" limitation. The homeowners association regulations contain the gratuitous statement that "excess assessments during a taxable year which are either rebated to the members or applied to their future assessments are not considered gross income." Reg. §1.528-9(a). However, it should be noted that some IRS personnel have taken the position that the quoted language applies only to organizations that have validly elected to be treated as a "homeowners association" under §528. FSA CC:TL-2114-92; FSA CC:TL-6262-92.

2. Amounts Held as Agent —

In the unusual situation in which amounts are paid by shareholder-lessees to a housing cooperative for a specified purpose that is not part of its normal functions — an example might be to pay a lifeguard at a local public beach — and the funds are kept segregated, such receipts probably would be held not to constitute income to the corporation.[505] The IRS has so ruled in the analogous condominium situation, based upon the conclusion that such funds were held in a fiduciary capacity by the corporation acting merely as agent for the contributors.[506]

[505] *See* PLR 9039011 (health insurance premiums; segregation not required).

[506] Rev. Rul. 75-370 (funds to be used by condominium association to replace the roof and elevators on building that it did not own), discussed in GCM 36188 (Mar. 11, 1975). *Cf. Lake Petersburg Ass'n v. Commissioner*, T.C. Memo 1974-55; PLR 8142011 (board of managers of two-unit condominium ruled, without explanation, not to have income upon collecting real estate taxes, mortgage interest, insurance premiums, management fees and all other expenses from the many co-owners of one of the units).

Note: In the condominium context, it is also not uncommon for the association to receive funds from third parties on

behalf of some or all of the unit owners (e.g., in settlement of claims for damages to individual units and/or the common elements[507] or on sale of property held in the association's name as nominee for the unit owners[508]), which are then treated the same as any other funds held by the association as agent for the unit owners involved.[509]

[507] *See, e.g.,* Rev. Rul. 81-152; PLR 200439017, PLR 9238021. *Cf.* PLR 9343025 (similar issue as to a non-condominium homeowners' association). Rev. Rul. 81-152 was applied in PLR 9335019 in a situation presenting numerous issues concerning funds or benefits moving between the association and the unit-owners. The reader is cautioned that some of the holdings seem questionable.

[508] PLR 199934013.

[509] If ownership is transferred to the association, the transaction is treated as a contribution to capital by the unit owners. PLR 9238021. *Cf.* PLR 9343025 (similar issue as to a non-condominium homeowners' association).

3. Payments Received for Stock (§1032) —

The Code provides that "[n]o gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation,"[510] and the IRS has repeatedly ruled privately that the provision applies to the sale by a housing cooperative of its own shares.[511]

[510] §1032.

[511] PLR 200645002, PLR 200513020, PLR 200327058, PLR 8920063, PLR 8803023, PLR 8712044, PLR 8503036, PLR 8235086. *Cf.* PLR 9039011 (relying on §118 rather than §1032), PLR 9010045 (same).

As indicated, for this purpose there is no distinction between treasury shares — i.e., shares that were issued to someone and then acquired by the issuing corporation (as opposed to being retired or canceled) — and authorized but unissued shares. And the same non-distinction applies at the other end of the shares' life cycle; another Code section provides that, for purposes of the redemption rules, "stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder . . ., whether or not the stock so acquired is canceled, retired, or held as treasury stock."[512] Based on those rules, and the legislative history behind them, it was, and probably still is, the position of the IRS that Congress intended "to eliminate the formalistic distinctions that had existed under the pre-1954 Code law with respect to treasury stock," so that for all purposes "a corporation's treasury stock is no different than its previously unissued stock."[513] It followed, said the IRS in Rev. Rul. 74-503, that, because previously unissued shares have a zero basis in the hands of the issuing corporation, treasury shares also have a zero basis in the hands of the issuing corporation — no matter how much the corporation might have paid for them.[514]

[512] §317(b).

[513] Rev. Rul. 74-503. Rev. Rul. 74-503 was revoked by Rev. Rul. 2006-2, which latter ruling stated that the above-described conclusions of Rev. Rul. 74-503 were under further study. Rev. Rul. 74-503 had cited especially S. Rep. No. 1622, 83d Cong., 2d Sess. 252 (1954). The distinctions that previously existed are discussed in *Penn-Texas Corp. v. United States*, 308 F.2d 575 (Ct. Cl. 1962).

[514] Rev. Rul. 74-503 also stated that it followed that the subsidiary's shares received by the parent in exchange for its own shares would have a zero basis in the hands of the parent. As noted above, those conclusions are being rethought and might change.

4. Capital Contributions (§118) —

Although payments made to a corporation for its own shares are sometimes referred to as "capital contributions,"[515] that is not the usual terminology for amounts paid to a housing cooperative for its stock and it is not employed here. Such payments are discussed immediately above.

[515] See, e.g., PLR 8516020, in which the IRS referred to a shareholder's purchase of shares allocated to a parking space as being "in the nature of an additional capital contribution." For an analytical discussion of the cases and the underlying principles, see Miller, *Unit Owners and Capital Contributions,* 10 J. Real Est. Tax'n 38 (1982).

Amounts paid to a housing cooperative as rent are income.[516] Amounts paid as a contribution to capital are not income.[517] Although those points are clear, it is not always easy to tell whether a given payment (or portion of a payment) made by the owner of a cooperative apartment is rent or a capital contribution. Aside from difficulties of factual analysis, there may also be significant disagreement about precisely what are the rules to be applied in making the distinction.[518] Some of the issues are discussed in the following paragraphs.

[516] §61(a)(5).

[517] §118(a); *Concord Village v. Commissioner*, 65 T.C. 142 (1975), *appeal dism'd* (9th Cir. 1977); PLR 200645001, TAM 9539001, PLR 9010045; TAM dated Dec. 18, 1962, addressed to District Director of the Manhattan District, a copy of which memorandum is in these authors' files.

[518] *See, generally,* Miller, *Amounts Collected from Unit Owners: Are They Subject to Income Tax?* 9 J. Real Est. Tax'n 351 (1982).

Note: We often see the issue come up in practice where a shareholder who has lived in the unit for many years as their principal residence decides to sell the shares. They are faced with determining their tax basis for purposes of gain calculation which basis is typically equal to original cost of the shares plus capital contributions. While they can easily determine the original cost from her purchase agreement, capital payments may be more of a challenge both in terms of locating historical records (not discussed further) and determining whether payments were properly treated as rent or capital.[519]

[519] Shareholders holding the unit for rental my prefer the characterization of the payments as rent to take a rental deduction.

a. The IRS Position —

The IRS approach has not always been consistent. It has traditionally taken the position that doubtful payments are properly treated as rent (so as to give rise to corporate taxable income).[520] Yet, the IRS has at times taken the opposite tack and urged that such payments are capital contributions (where characterizing them as rent might help the corporation pass the 80% gross income test[521]).

[520] *See Cambridge Apt. Bldg. Corp. v. Commissioner*, 44 B.T.A. 617 (1941); *874 Park Ave. Corp. v. Commissioner*, 23 B.T.A. 400 (1931).

[521] *See Eckstein v. United States*, 452 F.2d 1036 (Ct. Cl. 1971). That test is discussed below.

b. Need Not Be Voluntary —

Some points, at least, appear to be settled. Thus, whatever the rule in other contexts,[522] in the housing cooperative area it seems that a payment need not be voluntary in order to be a capital contribution. All of the housing cooperative cases discussed below involve payments that were made pursuant to an enforceable obligation.

[522] *Compare, e.g., United Grocers, Ltd. v. United States*, 308 F.2d 634 (9th Cir. 1962) (must be voluntary), and Rev. Rul. 57-375 (same), *with Board of Trade of the City of Chicago v. Commissioner*, 106 T.C. 369 (1996) (need not be voluntary), *and* PLR 200439017 (condominium association retaining funds it received as agent for unit-owners), PLR 9238021 (same). *See also* PLR 200027029 (assessment by incorporated non-exempt homeowners' association).

c. Enforcement Mechanism Irrelevant —

Although it might seem logical to hold that all amounts paid by virtue of a proprietary lease — and under threat of eviction — should be deemed to be rent rather than capital contributions, the courts have not adopted such a rule.[523] Their position is perhaps best explained by the notion that, the proprietary lease being regarded as being a mere adjunct to the stock and not having significance in its own right,[524] neither the presence of the obligation in the lease nor the nature of the remedy for its breach should be accorded weight for income tax purposes.

[523] *Eckstein v. United States*, 452 F.2d 1036 (Ct. Cl. 1971); *874 Park Ave. Corp. v. Commissioner*, 23 B.T.A. 400 (1931); *Lake Forest, Inc. v. Commissioner*, T.C. Memo 1963-39, *appeal dism'd* (4th Cir. 1964).

[524] *See* II.A.1., IV.E.4.b., VI.C.1., VI.E.2. and VIII.C.2., above.

d. The Purpose Test —

Before the advent of §216(d),[525] it seemed clear that amounts paid to the cooperative for essentially "capital" purposes — e.g., relevant mortgage amortization,[526] replacement reserves, addition of new assets or capital improvements — could be treated by it as capital contributions, much the same as similar expenditures by a conventional homeowner, provided that (1) the amounts in question were specifically earmarked and restricted in use to such capital-type purposes, (2) the documents characterized them as capital contributions, and (3) they were consistently treated as capital items rather than income items on the books of the corporation.[527] What the result would have been if any of these elements were missing was uncertain.[528]

[525] *See* VI.A.2., above; Miller, *Section 216(d) Poses New 80/20 Threat,* 16 J. Real Est. Tax'n 89 (1988).

[526] *But see* H.R. Rep. No. 658, 94th Cong., 1st Sess. 328 (1975); S. Rep. No. 938, 94th Cong., 2d Sess. 396 (1976); Staff of the Joint Committee on Taxation, Explanation of Tax Reform Act of 1976, p. 602 (1976), all saying that assessments to pay mortgage principal are includible in gross income.

[527] *50 E. 75th St. Corp. v. Commissioner*, 78 F.2d 158 (2d Cir. 1935); *Eckstein v. United States*, 452 F.2d 1036 (Ct. Cl. 1971); *Concord Village, Inc. v. Commissioner*, 65 T.C. 142 (1975), *appeal dism'd* (9th Cir. 1977); *Park Place, Inc. v. Commissioner*, 57 T.C. 767 (1972); *Cambridge Apt. Bldg. Corp. v. Commissioner*, 44 B.T.A. 617 (1941); *874 Park Ave. Corp. v. Commissioner*, 23 B.T.A. 400 (1931); *Lake Forest, Inc. v. Commissioner*, T.C. Memo 1963-39, *appeal dism'd* (4th Cir. 1964); Rev. Rul. 75-371, discussed in GCM 36188 (Mar. 11, 1975); I.T. 1469, declared obsolete in Rev. Rul. 71-498. *Cf. Lake Petersburg Ass'n v. Commissioner*, T.C. Memo 1974-55. *See also* Rev. Rul. 74-563 (homeowners association received segregated funds earmarked for paving parking area); PLR 200339002 (homeowners association received funds to pay down mortgage).

[528] It has been held that an absence of a use restriction is fatal. *James Hotel Co. v. Commissioner*, 325 F.2d 280 (10th Cir. 1963); *Concord Village, Inc. v. Commissioner*, 65 T.C. 142 (1975), *appeal dism'd* (9th Cir. 1977). *Cf. Edison Club v. Commissioner*, T.C.

Memo 1975-19, *aff'd per curiam*, 535 F.2d 1241 (2d Cir. 1975).

Comment: If treatment as capital contributions is the desired result, the proprietary lease and other documents should spell out all three of the above elements. These authors have found it useful to specify that all amounts used to amortize capital-type mortgages are automatically to be treated as capital contributions and to provide that the board of directors has discretionary power to earmark other capital-type amounts for treatment as capital contributions. Although not required, it might be helpful to keep the earmarked funds in a segregated bank account.[529]

[529] Some interesting discussions, albeit in a different context, of what is meant by "earmarking" amounts (including the effect or non-effect of commingling funds) in deciding whether certain receipts by a club should be treated as in effect capital contributions are found in *Maryland Country Club, Inc. v. United States*, 75-2 USTC ¶16,190, *38 AFTR2d 5636* (D. Md. 1975) (receipts not sufficiently "earmarked"), *rev'd*, 539 F.2d 345 (4th Cir. 1976) (receipts sufficiently "earmarked"), *AOD 1976-15* (disagreeing with Fourth Circuit decision but, because the law had been repealed, deciding not to seek Supreme Court review), and *Gibbons v. United States*, 277 F. Supp. 749 (S.D. Ill. 1967) (receipts not sufficiently "earmarked"). The issue and how it arose are both well described in the following passage from the Fourth Circuit's opinion:

> Former §4241 of the Internal Revenue Code of 1954, imposed a twenty percent excise tax on dues or membership fees and initiation fees paid to any social, athletic or sporting club. Former §4243, however, exempted such dues and fees from the tax if they were paid for capital improvements, or furnishings or fixtures required as a result of capital construction, and used for such purposes within three years. A regulation, *26 C.F.R. §49.4243-2(b)(iii)*, provided that even if otherwise exempt under §4243, such dues and fees would not be exempt "unless they are earmarked by the club or organization at the time of receipt for use [for an exempt purpose]." This case raises a question of whether certain initiation fees, membership fees and special assessments collected by Maryland Country Club, Incorporated (Country Club) were sufficiently "earmarked" to entitle them to tax exemption.

Why then should later contributions additionally have to pass a purpose test?

e. The Tracing Problem —

One of the necessary steps in applying the purpose test is to determine what portion of a given maintenance payment has been earmarked for a capital-type purpose. In principle it would seem that each payment should be broken down proportionately, in accordance with the corporation's expenditures, into a rent portion (representing the apartment's share of the cost of operating the property) and a capital contribution portion (representing the portion contributing to an increase in the shareholder-lessee's equity).[530]

[530] *Bear Valley Mut. Water Co. v. Riddell*, 283 F. Supp. 949 (C.D. Cal. 1968), *aff'd per curiam*, 427 F.2d 713 (9th Cir. 1970). Unless all receipts are from shareholder-lessees, there presumably will also be equity increases attributable to the profit element in dealings with others. Thus, it is not correct to assume, as some courts have done, that the aggregate increase in shareholder equity must always equal the total of capital contributions. *See Eckstein v. United States*, 452 F.2d 1036 (Ct. Cl. 1971).

Comment: In making any such allocation, one would have to bear in mind that the rent portion of maintenance charges is almost always less than the fair rental value of the apartment, since the rental charged by a conventional landlord normally includes, in addition to amounts necessary to carry the property, amounts for mortgage amortization and other capital-type items, as well as a return on investment. It follows that fair rental value simply would not be a factor in making the determination.

In any event, there were cases holding that the parties were free to designate just what funds were to be considered as having been used for capital-type purposes — even to the extent that 100% of a shareholder-lessee's maintenance payment might qualify as a capital contribution.[531]

[531] That was squarely held in *874 Park Ave. Corp. v. Commissioner*, 23 B.T.A. 400 (1931), and would seem to be a necessary conclusion from the principles enunciated in most of the other cases cited in VIII.C.4.d., above.

f. Voluntary Characterization as Rent —

Whether or not there were limitations on the corporation's freedom to characterize maintenance payments as capital contributions, it appeared for a time that any corporate characterization as rent would be respected.[532]

[532] *See Eckstein v. United States*, 452 F.2d 1036 (Ct. Cl. 1971). *50 E. 75th St. Corp. v. Commissioner*, 78 F.2d 158 (2d Cir. 1935), is not to the contrary; there the entire payment was characterized as a stock assessment.

A housing cooperative might well desire such a characterization — even amending the relevant documents in order to bring about this result — where it is skating on the 80% gross income brink and therefore wishes to maximize "gross income . . . derived from tenant-stockholders."[533]

[533] *See* IV.G.3., above.

Comment: Inasmuch as a rent-or-capital-contribution characterization is not in principle optional — and could not properly be optional so long as no rule requires consistency as between a corporation and its shareholders — it may be dangerous for a housing cooperative to rely on such a procedure. Also, it may be that the addition in 1986 of a provision dealing with claimed "rent" deductions by shareholder-lessees will bring about the development of characterization rules that will be controlling for all income tax purposes.[534]

[534] *See* VI.A.2., above; Miller, *Section 216(d) Poses New 80/20 Threat,* 16 J. Real Est. Tax'n 89 (1988).

In that connection, note must be taken of the following discussion in Rev. Rul. 75-371:

> With respect to regular assessments, section 61 of the Code defines gross income as all income, from whatever source derived, except as otherwise provided by law. Funds collected by a nonexempt organization by means of assessments for the purpose of normal operating expenses are taxable as ordinary income under section 61. Any funds accumulated as contingency reserves are also includible in the organization's gross income because the Internal Revenue Code does not provide for such accumulations without tax consequences.[535]

[535] Although the organization there involved was a condominium management association, the same principles would seem to apply to a housing cooperative.

Query: Can a "cooperative housing corporation" avoid an 80/20 gross income problem simply by collecting unneeded amounts from its "tenant-stockholders" and calling such excess funds contingency reserves?

g. "Flip Taxes" —

As to the possibility that so-called "flip taxes" might be treated as capital contributions, see IV.G.3.b.(1), above.

5. Receipt from Seller to Cooperative —

In one case the question was raised whether a payment received from a third party — the seller of the building to the housing cooperative — constituted income. The seller, as an inducement to the sale, had guaranteed that the income from the garage and some stores would not fall below a certain level. It did, and the seller made up the difference. The court rejected the contention that that payment constituted an adjustment of the purchase price rather than income. It noted that the corporation had designated the payment on its books as income, that the payment "certainly flowed to the cooperative in respect of commercial space," and that "[to] the cooperative it made no difference whether such rental income was produced from leases or from the guarantee."[536]

[536] *Eckstein v. United States*, 452 F.2d 1036 (Ct. Cl. 1971).

D. Qualification as Certain Other Organizations

1. Section 501(c)(12), (c)(4), and Other Exempt Provisions Not Applicable —

The IRS has ruled that a cooperative organization which operates and maintains a housing development and provides housing facilities and maintenance services on a cooperative basis for the personal benefit of its tenant-owner members does not qualify for exemption as an organization described in §501(c)(12) (dealing with mutual benefit organizations) or any other provision of the Code.[537]

[537] Rev. Rul. 65-201. *Cf.* Rev. Rul. 74-17 (condominium association not exempt under §501(c)(4) as social welfare organization); Rev. Rul. 69-280 (same as to homeowners association). To the same effect, see *Lake Petersburg Ass'n v. Commissioner*, T.C. Memo 1974-55. *See also Rancho Santa Fe Ass'n v. United States*, 589 F. Supp. 54 (S.D. Cal. 1984), and the revenue rulings cited therein; PLR 200846034, PLR 200817064, PLR 200809035, PLR 201631014, and PLR 201701019.

2. Section 528 Not Applicable —

The rules of §528, a section added in 1976 under which certain "homeowners associations" (including "condominium management associations," as discussed at X.B., below) are not taxable on certain payments received from members, do not apply to "cooperative housing corporations."[538]

[538] Reg. §1.528-1(a). Presumably, the same rule would apply to any other housing cooperative.

But see PLR 201515009, in which the IRS said it was proper for a trailer-park land-only cooperative corporation to be treated as a homeowner association reporting under §528, notwithstanding that, in the words of the ruling, "an interest in Corporation confers rights similar to those held by a tenant-stockholder in a cooperative housing corporation."

3. S Corporation Status Not Prohibited —

There is no apparent reason that a "cooperative housing corporation" should not be able to make a Subchapter S election, although there may be limits on the effectiveness thereof.[539] The Office of Chief Counsel has stated that "Assuming that the cooperative housing corporation meets the statutory requirements set forth in subchapter S, we know of no basis for denying S corporation status to it."[540]

[539] *See* PLR 8440020. These authors have participated in a study of electing S status for a coop with less than 100 units. The procedural impediments are formidable and include getting representations that each owner is qualified (consider not only qualified status in general, but also changes from transfers on sale or death, determining qualified S status of various types of trust shareholders, immigration status, etc.) and obtaining taxpayer IDs from each owner. The tax benefits may be questionable (for example NYC does not recognize S status), and owners may not wish to report income on their personal returns from commercial income.

[540] GCM 39289 (May 25, 1984) (reviewing PLR 8440020 in proposed form). Query, any change since the Tax Court concluded in 1995 that the cooperative housing corporation is also subject to Subchapter T (and how would they work in tandem with S corporation status?).

4. Filing —

If a "cooperative housing corporation" is "operating on a cooperative basis," it, like any other corporation so operating, must report on Form 1120-C, rather than Form 1120.

B. The Ground-Up Condominium or Cooperative Developer

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For the most part there are no special rules or concerns that apply because a condominium or cooperative is involved in the construction and sale of the residential units; for income tax purposes the situation is essentially the same as that of a subdivider selling individual houses, a topic beyond the scope of this Portfolio. There are two potential exceptions to this rule that we have seen in practice during the last few years.

Regarding construction accounting under §460 for long-term contracts, individual condominium sales are not generally afforded the same "home construction contract" exemption from the application of the percentage of completion method of accounting as are individual home, townhouse and rowhouse sales.[712] This can result in the recognition of income in a given year without a corresponding payment by the purchaser (i.e., phantom income). The other potential difference relates to the eligibility of condominium sales for the favorable tax rate enacted under the Tax Cuts and Jobs Act (TCJA) for qualified business income.[713] Eligibility may effectively reduce the top marginal rate on such income for individuals from 37% to 29.6%.[714] Both issues are discussed below.

[712] §460(e)(1)(A). See the discussion immediately below.

[713] §199A. Both the home seller and the condominium seller face this eligibility requirement and may have differing paths to success. See the discussion below relating to condominiums. For a detailed discussion of qualified business income see 537 T.M., *Qualified Business Income Deduction: Section 199A.*

[714] The home, townhouse and rowhouse seller have similar concerns but the outcomes may vary depending on their other holdings. See the discussion in XIII.B.2., below.

1. Section 460 Home Construction Contract Exception —

Comment: When the condominium market is hot, and subject to state law, sponsors can often "pre-sell" the units. That is, contracts for sale can be obtained before the building is completed and, in some cases, as soon as building plans are filed with the local building authorities. In those cases, buyers execute agreements while nothing more exists on the ground than an empty lot with buyers basing their decisions on building plans or other drawings of the units they wish to

acquire. Closings in those scenarios take place in the next year or more when the building is completed and has obtained a temporary certificate of occupancy.

This fact pattern gives rise to the percentage of completion method of accounting under §460.[715] In short, such method provides that the anticipated taxable income from a long-term contract, meaning a binding contract for construction, manufacturing, rehabilitation or installation entered into in a year but not completed until the following year or later, is recognized as the percentage of overall anticipated costs are incurred.[716] The amount of consideration received by the developer is irrelevant, thus it is conceivable that a developer must include significant income in a given year without corresponding proceeds from the purchaser.

[715] For a detailed discussion of §460, see 575 T.M., *Accounting for Long-Term Contracts.*

[716] The regulations provide that for purposes of the date a taxpayer enters into a contract, it is the date the contract binds both the taxpayer and the customer under applicable law, even if the contract is subject to unsatisfied conditions not within the taxpayer's control (such as obtaining financing). Reg. §1.460-1(c)(2).

In manufacturing or construction-related businesses, this may not cause the contractor much concern as the contracts will typically require that buyers make progress payments over the term of the contract. In the individual residential market, local law or custom may prevent the contractor from requiring progress payments or being allowed to use the standard down payments the buyer has provided at execution of the agreement, until completion of the contract. For example, in New York a typical down payment or option payment from the buyer of 10% or 20% for a condo or co-op unit cannot be used by the developer until the contract has closed or the buyer has walked away from the contract.[717] Perhaps for this reason, §460 exempts home construction contracts from percentage completion method and allows the completed contract method.[718] The latter effectively both permits and requires income recognition in the more traditional year of closing.

[717] Whether the same local rule applies for individual home sales is beyond the scope of this Portfolio.

[718] §460(e)(1).

The key question for condominium and cooperative developers is whether the contract for the sale of their units qualify as “home construction contracts” within the meaning of §460(e)(5)(A). The statute refers to home construction contracts as those for dwelling units in buildings containing four or fewer dwelling units and that for this purpose, each townhouse and rowhouse shall be treated as a separate building. Notably absent is the condominium and cooperative unit. Thus, condominium units in buildings containing five or more units do not fit within the literal language of the statute.

Proposed regulations included the provision that each condominium unit shall be treated as a townhouse.[719] If adopted, condominium sales would be eligible for completed contract accounting, but to date the proposed regulations have not been finalized. Developers are therefore unable to rely on the proposed regulations.[720] Bloomberg journal authors Blake D. Rubin, Andrea Macintosh Whiteway, and Jon G. Finkelstein[721] suggest various workarounds, focusing on whether the developer is subject to §460 as a threshold matter and the “binding” contract requirement. That is, if there is no binding contract at execution, completion cannot occur in the year or years following, a predicate to the application of §460. The authors examine other Code authorities on the binding contract rule that provides more detailed analysis of what constitutes a binding contract. A two-part test forms the basis for the binding contract under those authorities. In addition to the mutual binding of the parties under the §460 regulations, the cited authorities also hold that the contract must not limit damages to less than 5%. It follows that if either test is not met, there is no binding contract. Thus, since residential contracts are generally binding in that both parties are legally bound,[722] one approach has been to consider the other test, down payments of less than 5%. However, many sponsors are loathe to permit such low non-market deposits.

[719] REG-120844-07, 73 Fed. Reg. 45,180 (Aug. 4, 2008). We note that cooperative units are not included.

[720] For an analysis of the Proposed Regulations see Rubin, Whiteway, and Finkelstein, *Planning Opportunities for Developers Waiting for Long-Term Contract Rules,* Real Est. J. (Aug. 3, 2011).

[721] *Planning Opportunities for Developers Waiting for Long-Term Contract Rules,* Real Est. J. (Aug. 3, 2011).

[722] *See* Reg. §1.460-1(c)(2)(i). Note, if either party can walk away from the deal there is no binding contract.

Comment: We have suggested a focus on the apparent failure to meet the mutual binding test under the regulations with respect to New York properties. Under New York's Martin Act (the name of New York State's securities laws), a sponsor has the ability rescind the contract until the Attorney General declares that the offering of the units is effective, generally upon substantial completion of the building. Thus, since one party, the sponsor, has the right to unilaterally rescind, the contract does not arguably rise to the level of a binding contract until such time as the plan goes effective as it fails to meet the first requirement of the regulations, mutuality of obligations. The amount of the down payment deposit above 5% should not be relevant as the agreement should not be binding under the mutuality of obligation requirement of the regulations under §460.

Comment: Another approach to fail the binding contract definition in the regulations is to give the buyer an option to buy instead of an executed agreement to buy. Thus, one party would not be bound (in this case the buyer as opposed to the sponsor in the prior analysis). We have seen the use of non-refundable options in the 10%–15% range for purposes of avoidance of §460. Whether that would be effective is reasonable but as yet untested.

2. Section 199A Qualified Business Income Deduction —

Much has been written as to whether a seller of homes or condominiums is eligible for capital gain treatment, with the alternative being ordinary income treatment. A developer acquiring or constructing buildings containing dwelling units for sale to the public would not be eligible for capital gain treatment and that would generally end the inquiry.[723] Effective with the TCJA through the end of 2025, a second favorable ordinary income rate came into existence. To be eligible, the income must meet the tests of “qualified business income.” A 20% deduction is allowed for “qualified business income” that effectively reduces the top rate on ordinary income from 37% to 29.6%, which brings it closer to the top rate on capital gain of 20%.[724]

[723] The definition of capital asset and some of the publications on the subject are discussed in the following section.

[724] Even closer if the capital gain seller is subject to the 3.9% tax under §1411 as well as the 25% rate on §1250 recapture income.

An analysis of §199A is beyond the scope of this Portfolio.[725] For purposes of the condominium and cooperative developers, the biggest hurdle in achieving qualified business income status are the wage and property limitations. The 20% deduction is limited, on a business-by-business basis, to the greater of 50% of W-2 wages paid by the business for the year or 25% of W-2 wages plus 2.5% of the unadjusted basis of depreciable property held at year-end. Regarding the first test, the 50% of W-2 wages paid, the problem is that real estate concerns typically spend far less on W-2 wages and far more on 1099 contractor income for services than other industries. Recognizing that, Congress added the second test to allow utilization of the real estate industry's depreciable real estate base. The problem with that for the condominium and home sale developer is that its real estate is not depreciable.

[725] See 537 T.M., *Qualified Business Income Deduction: Section 199A,* for a detailed analysis.

To help the condominium and other real estate concerns, final regulations adopted Jan. 18, 2019 permit the aggregation of businesses to determine whether the owners meet the W-2 wage and property base.[726] But, you may ask, what good is aggregating more condominium buildings a developer may have? The answer is that a typical developer constructs not only condominiums for sale, but also builds or buys comparably sized rental buildings. Further, it is not uncommon for a building in which the original building plans submitted are for a condominium, to change its purpose to a rental building as construction proceeds and the market for condominiums suddenly sours.[727] Thus, aggregating businesses allows the developer to borrow depreciable basis from a rental business to use for its dealer business, although care should be taken not to harm the rental business' rights under §199A.

[726] Reg. §1.199A-4(b)(1).

[727] For a detailed analysis of the regulations see Mark Stone, *Did Condo Dealers Catch a 20 Percent Break Under Section 199A?* Tax Notes, Apr. 1, 2019.