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TAX CONSEQUENCES OF MULTIPLE OWNER REAL ESTATE INVESTMENT

WILLIAM J. GOLDWORN*

REAL ESTATE INVESTMENT is probably the oldest means of accumulating wealth. It was man's first effort to establish a society predicated upon a stable economy. It distinguished between the slave and the free man and may be said to have been the first "status symbol." Even in our modern times, it is not uncommon to require ownership of land as a condition to exercise the privilege of voting. Personal property most certainly was and is of importance, but such property came into being as an adjunct to trade; land was the indicia of true wealth.

Property ownership today has entered the realm of big business. It is no longer economically feasible to consider the acquisition of real estate for either the production of income or ultimate capital gain unless one is prepared to invest substantial sums of money. The costs of management, maintenance, and general operation have risen astronomically in recent years, and, when coupled with the declining rate of return, have tended to discourage the small investor. Diversification of investment has become the watchword, following the old maxim of "not putting all of one's eggs in one basket." This concept has created the era of the syndicate.1

This article will explore the area of multiple owner real estate investment. By the term "multiple owner," the author indicates that title to property is in the name of more than one individual or entity, and will include the concept of the trust. With the exception of the Small Business Corporation,2 the article will avoid reference to corporate activities unless the entity is integrated with some other form of property ownership.

In almost every instance, the consideration of a new real estate venture will raise a question of what form of business organization

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1 The term as used here indicates multiple owner investment generally and not the term as applied specifically to a single form of business venture.

2 Int. Rev. Code of 1954, § 1371 (The code will hereinafter be referred to as IRC in the footnotes).
to be used. It is impossible to foresee or take into account every possible situation which may arise. Consideration must be given to the objectives of the investor, including his business objectives and tax problems. Primarily, the business objectives must be considered before the tax consequences. These business considerations may be said to include the following:

1. centralization of management to the greatest possible extent;
2. a single title-holding entity, uninterrupted by death, probate of wills and like possibilities;
3. limitation of liability, where possible.

These objectives will usually have the greatest effect upon the choice of form of business. Superimposed upon them will be the tax objectives of the investor, which include the following:

1. income taxed at the lowest rate;
2. the avoidance of double-taxation;
3. capital gain on the sale of the property;
4. tax free return of the investment at the earliest possible date and to the largest extent;
5. repayment of the investment prior to sharing of the profits;
6. the number of participants, who they are and their individual tax brackets;
7. the nature of the business investment.

JOINT TENANCY AND TENANCY IN COMMON

Where real estate is owned jointly by a husband and wife, the problems are more limited in scope. Most of the business and tax objectives can be solved with minimum difficulty. State law must

3 Single owner being a form which will usually avoid double taxation. Corporations are therefore largely excluded. Electing corporations under the terms of Subchapter S of the IRC will be discussed in the article as these corporations may achieve a degree of single taxation.

be carefully examined since the basic duties and liabilities of the parties are controlled by statute and case law. Use of this form is generally limited to the ownership of a residence. Its application to income producing property exposes the owner to difficulties most often found in the tenancy in common.

The tenancy in common is ordinarily engaged as a property owning vehicle when the project is relatively small in scale and the number of investors is limited. This form is especially appropriate where the intention of the parties is solely to maintain the property and to collect rent, since these duties are not usually considered to be the conduct of a business, at least as far as the Internal Revenue Service is concerned. Again, state law will be an important factor, and with careful planning many of the ordinary liabilities can be avoided.

Tenancy in common has many advantages. It provides for the continuance of the investment beyond the death of the parties and permits free transferability of shares. It is in this manner that it differs from a partnership. A tenancy in common is also useful where most of the participants are investors, but one or more are dealers. In a joint venture or partnership the taint of dealership may effect the investor. In the tenancy in common, the investor reports his share of the income, and pays his own portion of the expenses. There is no partnership return to associate him with the dealer.

This form of doing business is not without its disadvantages. Upon the death of one of the investors, title to the property may be clouded by an unsettled estate, as state law usually requires all of the participants to sign the deed at the time of conveyance. This problem usually manifests itself where there are large groups of

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6 Treas. Reg. § 301.7701-1(c) (1960) indicates that local law is not controlling as to the determination of the business form of operation; Treas. Reg. § 1.761-1(a)(1) (1956) states, "Mere ownership of property which is maintained, kept repaired, and rented or leased does not constitute a partnership." These determinations are only determinative of necessity of complying with the requirement of filing returns.
7 For example, a mortgagors' liability may be avoided by providing in the mortgage that the mortgagee will look only to the property securing his loan for satisfaction.
8 E. B. Boyd Estate, 28 T.C. 564 (1957).
9 IRC § 761; see also Gilford v. Commissioner, supra note 5.
investors, and the desire has been to avoid centralized management and the possibility of taxation as a corporation.

Under normal circumstances, the tenancy in common will not be used by large groups. The more sophisticated investor can readily see the problems of control, operation, title transfer, and death of an investor. Such large groups will ordinarily choose a more complex form of business entity.

PARTNERSHIP

Partnerships are much broader in scope of meaning within the Internal Revenue Code of 195410 than that established by the Uniform Partnership Act or the Uniform Limited Partnership Act. A partnership is defined as being or including a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Code.11 Therefore, it becomes obvious that the tax consequences of this form of business are not dependant upon the status of state law, or the entity's adherence to form, but upon the operation of the Code and its application to associations.

A short restatement of basic partnership tax law is necessary before we apply the concept to real estate investment. The partnership form of operation has many benefits taxwise. It is not in itself a taxable entity,12 and need file only an information return.13 There is no double-taxation on the withdrawal of earnings,14 and items such as depreciation attributable to partnership property are directly available to the partners.15 There is no taxable event upon the transfer of property to the partnership16 except in the instance where an interest is given in the partnership in exchange for services,17 and even then, the time of the realization of the income de-

11 IRC § 761.
12 IRC § 701.
13 IRC § 6031 and the regulations promulgated thereunder.
14 IRC § 731(a)(1); taxed only to the partner and only to the extent the withdrawal exceeds his basis before the distribution.
15 IRC § 702(a)(8); IRC § 704(c)(1).
16 IRC § 721.
17 Treas. Reg. § 1.721-1(b)(1) (1956); taxed as income under IRC § 61, income being
pends on all of the facts and conditions or restrictions imposed on the partner.\textsuperscript{18}

The partnership's basis in the property is the same as the partners,\textsuperscript{19} except if the property contributed is subject to a liability which exceeds the basis of the transferor.\textsuperscript{20} The interest of the partners will shift when the property contributed is subject to a liability.\textsuperscript{21} The amount of the liability assumed is treated as the equivalent of a cash distribution in like amount to the contributing partner or partners. Each partner is entitled to include his share of partnership liabilities as a portion of his basis of his partnership interest. Thus, when the contributing partner's share of the partnership's liabilities is the same as the former share of the liability against the property, there is no problem of gain. If the partner's interest in the contributed property and the partnership differ, then his basis in the partnership will not be identical with his basis in the property.\textsuperscript{22}

The partners may determine amongst themselves the manner of distribution of the income of the partnership, as well as the allocation of the deductions.\textsuperscript{23} This allocation may be established to cover all items or only selected ones. Where the property has been held by the partners prior to the contribution by undivided interests, there is no need for an agreement since the Code provides that as long as the partners' respective interests in the partnership's capital and profits and losses remain identical to their former undivided interests in the contributed property, depreciation, depletion, and gain or loss will be allocated among the partners as if they still retained their undivided interest directly in the property.\textsuperscript{24}

In the consideration of the partnership form of business en-

\textsuperscript{19} IRC § 723; IRC § 732.
\textsuperscript{20} Treas. Reg. § 1.752-1(a) (1956).
\textsuperscript{21} Treas. Reg. § 1.722-1(a) (1956).
\textsuperscript{22} See Note 21 \textit{supra}.
\textsuperscript{24} IRC § 704(c)(3); Treas. Reg. § 1.704-1(c)(3)(I) (1956).
tity, as compared to the corporate form, there are several further advantages to be noted. The business losses are fully deductible by the partners. There is less exposure to the danger of penalties in a collapsible partnership than from a collapsible corporation. This problem will be discussed in some detail in another part of this article.

The application of these general rules to real estate investment produces several problems which merit consideration before the form of business entity is chosen. Careful analysis of the Code indicates that the general partnership has several disadvantages which should affect the thinking of the investor. Due to the usual long-range picture in real estate investment, there is a desire for security in the mind of the investor, at least as to the ability of the venture to reach the fruition of the original intent of the parties. Lack of continuity of life and centralization of management, both important to accomplish this aim, stand out among the shortcomings of the partnership form of investment. The absence of either or both of these characteristics, however, is what aids the avoidance of the commissioner deeming the venture an association taxable as a corporation. Therefore, if the partnership is terminable on death, or transfer of it requires the consent of the surviving partner to continue the business, or if the surviving partner has first refusal to buy the deceased's interest, there is no continuity of life within the meaning of the Code. The existence of these factors may affect this choice of entity as it may be more important to the investor that the integrity of his group remain intact until the property is disposed of, or until the original intent of the parties is carried out. This may be more important than the possible

25 Excluding Subchapter S of the Internal Revenue Code.
27 IRC § 751; the rules concerning collapsible partnerships are only intended to prevent the conversion of what would only be ordinary income into capital gains and finds its application limited to inventory items and "unrealized receivables." See also Friedman & Silbert, The Form of the Entity and its Capital Structure in Real Estate Acquisitions, 16th N.Y.U. Inst. on Fed. Tax 609 (1958).
28 IRC § 741.
29 In connection with Subchapter S Corporations.
30 The Uniform Partnership Act provided for dissolution on death of a partner.
31 Bloomfield Ranch v. Commissioner, 167 F.2d 586 (9th Cir. 1948); Poplar Bluff Printing Co. v. Commissioner, 148 F.2d 1016 (8th Cir. 1945); the characteristics of the association are set out in Treas. Reg. § 301.7701-2 (1960).
32a There are problems when partnerships change status either to a corporation or
characterization of the venture as an association. Again it must be emphasized that the intent of the parties and their desires and aims must be fully ascertained before it is possible to recommend a course of action.

There is a further disadvantage to be considered by each individual investor; that is, a distribution may greatly effect the partners’ tax rate. Individuals in high tax brackets are often favorably influenced by the maximum rate of 48% payable by a corporation, and by the ability of the corporation to accumulate its earnings to some degree without the requirement of a distribution, and limitations on rate and distribution may be considered by some to be a tax shelter. Situations such as these have aroused interest as to the potential use of a partnership and the cause is not completely lost. The investor seeking a limitation of his liability, as well as the benefits of the partnership in general, will explore a narrower phase of the area, the limited partnership.

**LIMITED PARTNERSHIP**

The limited partnership has had considerable success as a mode of acquiring, holding and operating real property. The term *syndicate* has often been applied to these forms of ventures. The limited partnership is not a cure-all and it is not without its dangers. Care must be exercised to avoid the classification of the limited partnership as in unincorporated association\(^3\) with the resulting undesirable tax consequences.

Thirty-nine states have adopted the Uniform Limited Partnership Act or a reasonable facsimile.\(^4\) The existence of appropriate legislation can be a significant value in tax planning, as well as providing other benefits.\(^5\)

The limited partnership extends many of the benefits of the

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\(^3\) See Rev. Rul. 63-107, I.R.B. 1963-23, 10 and David Wein Estate, 40 T.C. #51 (1963) for examples of possible problems.


stock company to the small investor. For example, a partner's interest is freely transferable; there is a degree of limited liability and, under most circumstances, continuity of existence depending upon the terms of the agreement.88

The problem in using the limited partnership is to avoid the classification as an association. The tests87 applied by the Commissioner for characterization as an association were first established in Morrissey v. Commissioner.88 These tests, stated simply, are: continuity of life, centralization of management, limited liability, and free transferability of interests. The application of these tests has led to several court decisions which have settled some of the ambiguity89 thus narrowing the problems somewhat.

Courts have tended to emphasize the importance of explicit terms in the agreement creating a limited partnership.40 The enactment of the Uniform Limited Partnership Act by the majority of states has given greater value to the past classifications. The Glensder case40a involved a situation which may be considered classic. The company was formed on the New York Limited Partnership Act with 4 general partners whose interest consisted of five-twelfths of the total invested capital, and 9 limited partners owning the balance. The agreement between the parties provided for centralized management in the general partners, as permitted by the New York Act, and that there would be no disruption of business on the death of a general partner. The limited partners were permitted to assign their interest and the general partners could add to the number of limited partners, if they so desired. The company seemed to have four of the criteria set in the regulations. Notwithstanding the established program the commissioner took the position that this was an association taxable as a corporation.

87 Treas. Reg. § 301.7701-2 (1960) gives several examples of the use of limited partnerships in acceptable manners.
88 Glensder Textile Co. 48 B.T.A. 176 (1942), acq., 1942-1 Cum. Bull. 8; Western Construction Co., 14 T.C. 453 (1950), aff'd, 191 F.2d 401 (9th Cir. 1951); Taywal Ltd., 11 P-H TC Memo 1044 (1942). Often the individuals may seek the characterization as an association where it may create substantial individual benefits, Kintner v. United States, 107 F. Supp. 976 (D.C. Mont. 1952), aff'd, 216 F.2d 418 (9th Cir. 1954).
40a Glensder Textile Co., supra note 39.
TAX CONSEQUENCES

The court in deciding for the taxpayer distinguished the limited partnership from a corporation (or an association taxable as a corporation) reasoning that the general partners interests were not transferable, their liability was unlimited, and on their death there was a conditional dissolution. Undoubtedly, the court was further influenced by the large financial interest of the general partners. The Treasury Regulations have classified a limited partnership as an association if there is centralized management and the partnership was not interrupted by death. Such a determination can have serious consequences to the investors as the classification as an association, in the absence of a proper election, is taxed under the corporate rates, and then the subsequent distributions to the partners is taxed again as dividends, subjecting the income to the dual taxation sought to be avoided. The court touched on this point in its dictum by inferring that if the general partners had not held such a large interest, the court might have considered the partnership an association.

To date, no court has specifically established a proportionate partnership test. In the Morrissey case, the court required only a representative body, and this would not depend upon the size of the interest of the general partners, but upon the power of the limited partners to subject the general partners to their will. The application of the Uniform Limited Partnership Act gives the general partner full authority in management, and this should be the test in these situations. In each case the specific provisions of the applicable state law will have immense influence upon the outcome of the treasury determination.

Free transferability is another indicia of a corporation, but in Glensder the court stated that the general partner could not transfer his stock, so there was a sufficient limitation to have removed this criteria from the group. The general partner was unable to impose the substitute in his place, the reasoning being that

41 See note 39 supra.
42 Treas. Reg. § 39.3797-5 (1942), which were in effect at that time.
43 Supra note 38.
44a Treas. Reg. § 301.7701-1(c) (1960).
45 Poplar Bluff Printing Co. v. Commissioner, 148 F.2d 1016 (8th Cir. 1945).
the security of the investment rests on the business ability and integrity of the general partners and was a specific factor in inducing the limited partners to participate.

An interesting question is raised when the general partner is without assets and/or is a dummy for the limited partners. Such a situation would seem to destroy the presence of unlimited liability of the general partner.\footnote{Western Construction Co., 14 T.C. 453 (1950), aff'd, 191 F.2d 401 (9th Cir. 1951); Driscoll, The Association Problem in Joint Ventures and Limited Partnerships, 17th N.Y.U. Inst. on Fed. Tax 1067 (1959).}

To re-capitulate the criteria of an association, it is imperative that each criteria be considered individually:

(a) \textit{Centralized Management}. The general partnership never has centralized management and so would not be affected and taxed as a corporation. The limited partnership lacks centralized management, unless substantially all the interest is held by the limited partners. Management would always be a part of the group, as the test is concentration of power to make decisions;\footnote{See Example 7, Treas. Reg. § 301.7701-2(g) (1960).}

(b) \textit{Continuity of Life}. Without qualification, neither the general partnership\footnote{Uniform Partnership Act § 31.} nor the limited partnership\footnote{Uniform Limited Partnership Act § 20.} has this attribute;

(c) \textit{Limited Liability}. Both forms generally lack this element, at least to the extent that it is not true of 100\% of the interested parties;

(d) \textit{Transferability}. General partnerships lack this element. Limited partnerships permit the limited partner to avail himself of this privilege.\footnote{Treas. Reg. § 301.7701-3(b)(2) (1960) (power of substitution).}

The principal disadvantage of the limited partnership is the required passive position of the limited partner. Variance from the path along the sideline can expose the limited partner to full and complete liability to the same extent as the general partner. The possibility of unlimited liability is a strong deterrent to the aggressive businessman's use of a limited partnership.
TRUSTS

Trusts have generally fallen out of favor as investment vehicles except in limited areas. In recent years, there has been a high probability of the trust being taxed as an association, as it more nearly resembles a corporation\(^5\) than any other entity. As a further limiting factor, the Code's definition of a partnership specifically excludes a trust, thus setting them apart for consideration.\(^6\) This problem has been resolved somewhat with the passage of Public Law 86-779.\(^7\) Section 10(a) added sections 856-858 to the Internal Revenue Code of 1954 and the Commissioner has since promulgated regulations to these sections.\(^8\) The trust provided for in these sections has become known as the Qualified Real Estate Investment Trust.

The Qualified Real Estate Investment Trust differs from the business trust\(^9\) and the common investment trust,\(^10\) not so much in its form or organization but in the restrictive nature of its mode of operation. By establishing itself as an investment trust, it is able to avoid the burden of double taxation, common to other trusts with broad ownership. As a result, the real estate trust is given the same treatment as the “mutual funds” under the provisions of the regulated investment company.\(^11\)

The real estate investment trust is intended to grant some additional benefits to the small investor and in practice should enable him to participate in larger projects normally outside his financial reach. The prerequisites of qualification, however, have a modifying effect upon loose speculation. In order to qualify, the trust may not engage in business, may not hold property primarily for sale to customers in the ordinary course of business, must have beneficial ownership in the hands of one hundred or more persons, as well as meet certain other requirements.\(^12\) In addition, the trust must make an election by computation of its taxable income

\(^{51}\) Treas. Reg. § 301.7701-4(b) & (c) (1960).
\(^{53}\) September 14th, 1960; for a history see Aronsohn, Syndicates, 18th N.Y.U. Inst. on Fed. Tax 63, 84 (1960).
\(^{54}\) April 25th, 1962.
\(^{55}\) Treas. Reg. § 301.7701-4(b) (1960).
\(^{56}\) Treas. Reg. § 301.7701-4(c) (1960).
\(^{57}\) IRC § 851-855.
\(^{58}\) IRC § 856.
as a real estate investment trust in its return for the first taxable year for which it wants the election to apply.\textsuperscript{59} Once the election has been made, it is irrevocable.\textsuperscript{60}

The trust operates in the form of an unincorporated trust or unincorporated association.\textsuperscript{61} The requirements for qualification must exist during at least 335 days of a 12-month’s taxable year, or a pro-rata portion of a shorter taxable year.\textsuperscript{62} The ownership of the shares of the trust must be widely dispersed so that less than fifty per cent is held either directly or indirectly by five or fewer individuals during the last half of a taxable year.\textsuperscript{63}

The Code provides that the trust must be managed by one or more trustees. The definition of a trustee is extremely broad in that it is defined as a person who holds legal title to the property of the trust, and has the rights and powers which meet the test of centralized management.\textsuperscript{64} The trustees may hold legal title in the name of the trust, in the name of one or more trustees or in the name of a nominee for the benefit of the trust.\textsuperscript{65} The test of centralized management will be met if the trustee has continuing authority over the management of the trust, conduct of its affairs, and management and disposition of the trust property. This authority must be exclusive except for the right of the shareholders to elect and remove trustees, terminate the trust, or ratify amendments to the trust instrument.\textsuperscript{66}

The operation of the trust properties is accomplished through the means of an independent contractor\textsuperscript{67} who renders the necessary services. The trustees may not be officers or employees of the independent contractor or directly or indirectly have a proprietary interest in such a company.\textsuperscript{68} The foregoing requirement is intended to assure that the trust be operated in a passive manner.

It appears that the regulations have excessively amplified the

\textsuperscript{59} IRC § 856(c)(1).
\textsuperscript{60} Treas. Reg. § 1.856-2(b) (1962).
\textsuperscript{61} The requirements are established in IRC § 856(a).
\textsuperscript{62} IRC § 856(b).
\textsuperscript{63} Treas. Reg. § 1.856-1(d)(5) (1962).
\textsuperscript{64} The tests are established in Treas. Reg. § 301.7701-2(c) (1960).
\textsuperscript{65} Treas. Reg. § 1.856-1(d)(1) (1962).
\textsuperscript{66} Ibid.
\textsuperscript{67} As defined in Treas. Reg. § 1.856-4 (1962).
\textsuperscript{68} Treas. Reg. § 1.856-1(d)(1) (1962).
terms of the code, and unnaturally separated the management from
the investment,\textsuperscript{69} which may tend to create a dangerous schism
leading ultimately to excessive management costs destroying the
initial appeal to the investor.

The manner of operation of a trust has been the subject
matter of numerous articles,\textsuperscript{70} and is beyond the scope of this ar-
ticle. However, the manner of the distribution of income and the
manner in which it is taxed is of interest.

A real estate investment trust is taxed on its income as an
ordinary corporation unless it distributes at least ninety per cent
of its real estate investment trust taxable income as taxable divi-
dends.\textsuperscript{71} Real estate trust taxable income does not include capital
gains, which are computed and paid separately. The investor is
taxed at ordinary income tax rates on his return and is not able
to avail himself of the exclusion, credit or deduction for dividends
received benefits.\textsuperscript{72} Capital gains are taxed to the beneficiary as
long term capital gains.\textsuperscript{73} The trust is taxed on the undistributed
capital gains, thus suggesting an attempt to force distribution.
The capital gains dividend must be declared in writing and mailed
to the shareholders at any time prior to the expiration of 30 days
after the close of the taxable year.\textsuperscript{74}

Some further beneficial treatment exists in that the real estate
investment trust may elect to treat all or part of any dividend paid
after the end of a year as made during the year if the dividend is
declared before the filing of the tax return and paid not later than
the first regular dividend payment made after the declaration but
no later than 12 months after the end of the year.\textsuperscript{75} The shareholders
must be given notice, but need not report the dividend until
the end of the taxable year in which it is paid.\textsuperscript{76}

It is interesting to note that a limited partnership under state
law can meet all of the requirements of a real estate investment

\textsuperscript{69} Kilpatrick, \textit{Taxation of Real Estate Investment Trusts and their Shareholders},
\textit{39} Taxes 1042, 1050 (1961).
\textsuperscript{71} Treas. Reg. § 1.857-1(a) (1962).
\textsuperscript{72} IRC § 857(a).
\textsuperscript{73} IRC § 857(b)(3)(B).
\textsuperscript{74} IRC § 857(b)(3)(C).
\textsuperscript{75} IRC § 858(a).
\textsuperscript{76} IRC § 858(b).
trust. The definition of a trustee could include general partners when the centralized management test is met. The regulations provide that the centralized management test is met by a limited partnership formed under the Uniform Limited Partnership Act or a similar statute, provided all of the interests in the partnership are held in such a manner that substantially all of the interest is owned by the limited partners. This position is contrary to the court holding in the Western Construction Co. case, wherein it was stated that the general partners could not be "dummy's" to limit the liability of the limited partners. However, the establishment of this control factor in the regulations should negate any litigation along these lines.

In considering a real estate investment trust as a vehicle, it is necessary to consider the status of the law in the various states. Several states have passed specific statutes to deal with the investment trust as established in the Internal Revenue Code. Generally, the states which have passed specific statutes regulating these types of trusts have restrictive business trust codes on their books. The trust can be a substantial factor in the investment picture if it can show a satisfactory return to its investors. However, recent events have cast clouds on the trust horizon. It is questionable if the investor would place his funds in the hands of the trustee without a greater feeling of security than now exists. The shares serve as little more than "over-the-counter" stock with its incumbent marketing problems.

**Condominiums**

Although the term "condominium" is strange to the common law lawyer, the concept is said to have its origin in the hills of ancient Rome. Certain civil law countries have used the term in their codes. The present statutory meaning in the United States indicates individual ownership in fee simple of single units in a

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80 California and Texas are prime examples.
81 Puerto Rico Laws Anno., Title 31 § 1291 (Supp. 1910); Spanish Civil Code, Title III, Art. 996.
multi-unit structure with all public elements being owned in common with the owners of the other units.\textsuperscript{82}

In Illinois, the fractions of the property owned in common are called "common elements" and those owned individually are "units." A "Unit Owner," therefore, would be one whose "estate[s] or interest[s], individually or collectively, aggregate fee simple absolute ownership of a unit."\textsuperscript{83} Generally, the deeds to each apartment or office are recorded separately, with each deed containing covenants as to the public elements. The Illinois statute provides that the two interests, free and common, shall not be separated and that a conveyance of the unit alone shall be deemed to pass the owner's interest in the common elements.\textsuperscript{84} Good draftsmanship, however, would require a complete and adequate legal description of the owners interest.

The individual unit, i.e., apartment, may be taxed separately and may be mortgaged separately as a result of federal housing legislation.\textsuperscript{85} Yet the cooperative apartment owner is entitled to the same deductions which are applicable to individual home-owners under the present tax laws.\textsuperscript{86} A recent addition to the National Housing Act provides that F.H.A. insurance of first mortgages may be "given to secure the unpaid purchase price of a fee interest in, or a longterm leasehold interest in a one-family unit in a multi-family structure and an undivided interest in the common areas and facilities which serve the structure."\textsuperscript{87} Inferentially this refers to condominiums. Other F.H.A. regulations indicate that property taxes in the jurisdiction where the family units are located must be assessed against each family unit as a taxable entity and not against the multi-family structure.\textsuperscript{88} The result is that taxes must be assessed against the apartment itself together

\textsuperscript{82} See Condominium; An Introduction to the Horizontal Property System 11 DePaul L. Rev. 319 (1961).
\textsuperscript{87} FHA Regulations, § 234 (1950).
\textsuperscript{88} Id., § 234.26(d)(3) (1950).
with the owner’s fractional interest in the common elements as a unit.

As far as local taxes are concerned, as an example, the Illinois Condominium Property Act provides:

Real property taxes, special assessments, and other special taxes and charges of the State of Illinois or of any political subdivision thereof, or other lawful taxing or assessing body, which are authorized by law to be assessed against and levied upon real property shall be assessed against and levied upon each unit and the owner’s corresponding percentage of ownership in the common element as a tract, and not upon the property as a whole.88a

The condominium differs somewhat from co-ownership and stock-lease cooperatives. In these forms the tenant has an undivided fractional interest. It may be questionable, even in the light of recent F.H.A. regulations, as to whether or not the interest can be mortgaged due to the restrictions on transfer and often required membership in the corporation or unit.

In the stock-lease form of cooperative the corporation owns the property and leases an apartment to the stockholder as an incident of his stock ownership and subject to restrictions in the by-laws. The property cannot be mortgaged separately nor may the apartment be sold separately from the stock, which may or may not be restricted. There is no protection to the stockholder against foreclosure which would destroy the owner's interest.

As presently established, the condominium has none of these restrictions.88b It is, in fact, the most stimulating development in cooperative apartment housing to occur in the past several decades.

This form of investment may be of interest to an investor with a specialized interest in apartment ownership. Civil law countries find condominiums useful in a multitude of property ownership situations. The concept may well find a broader use and acceptance as it becomes established in the public eye, and may well influence the broadening of property ownership. It could well effect the doctrines of tenancy in common. A marriage of the two

88b Puerto Rico requires that the seller give the right of first refusal to the condominium. In Gale v. York Center Community Cooperative, 21 Ill. 2d 86, 171 N.E.2d 30 (1961), the court upheld a comparable restraint in the deed.
principles would certainly be an asset to the property world. Experiments have been tried along the borders of such mergers. A common example is the section line road, or easement for ingress or egress. Often such properties, although title may be in a single property owner, requires cooperative maintenance of the artery. This application is only a step removed from the condominium.

The cooperative mentioned previously is not far removed from this theory. Marketing cooperatives have lead to production cooperatives. The strangeness of this theory to our thinking is its vertical nature, such being contrary to the common law idea of ownership of air and space above the property. The condominium does not invade this concept but simply, for the first time, permits the sale of the air space devoid of independent ownership of the ground base, this being cooperative in nature and free of joint obligation or liability. This is a most interesting development and bears consideration on a broad plane.

**Subchapter S Corporations**

This development is a modification of the tax structure as it may concern closely-held corporations. Although not strictly within the structure of the multi-owner concept of real estate investment, it deserves some consideration, as it may be of use to the developer or promoter.

Our tax laws have been modified due to the interest of the government in stimulating small business.\(^8^9\) It is often heard that this form of corporation is taxed as a partnership. Nothing could be further from the truth. Congress did not intend the tax to have such an interpretation.\(^9^0\) In fact the subchapter S corporation is subject to all of the corporate tax provisions not specifically excepted by the new Code provisions.

In order to qualify the corporation within the structure of the subchapter S provisions, it must meet the pre-requisites of a small business corporation.\(^9^1\) This is defined as a domestic corporation with one class of stock whose stockholders are residents or citizens

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\(^8^9\) IRC § 1371 et seq.


\(^9^1\) IRC § 1371(a).
of the United States and no more than ten in number, and all
individuals or estates. Further, the corporation must elect to be so
treated, and is automatically deprived of such status when it
ceases to be a small business corporation. The income of the
corporation is completely distributed in each year either by actual
distribution or by constructive distribution.

Those types of operation are subject to several limitations
which may act to destroy their usefulness in the investment field.
The stock may not be freely transferable due to limitations placed
upon it by the stockholders. The purpose would be to prevent the
stock being so distributed as to increase the number of stockholders
to an excess of ten. Such corporate limitations would serve to no
avail in the event of the death of a stockholder and the subsequent
transfer from the deceased's estate to a multitude of heirs. A fur-
ther limitation may be found in the inability of a corporation or a
trust to be a stockholder. In addition, a sale to a new stockholder
would require a new election to be filed, and once the election is
made it cannot be changed without one of the disqualifying trans-
actions occurring.

Although the subchapter S corporation has a resemblance to
a limited partnership in that there is no corporate tax rate in effect
and there is a limited liability to the limited partner together with
some degree of centralized management, the differences are sub-
stantial enough to complete the characterization as distinct. For
example, the limited partner has no management control other
than to approve of the general partners; and, the general partners
have no limited liability.

In comparing the two forms of business, it may be concluded
that the subchapter S corporation challenges the limited partner-
ship as an alternative without the dangers inherent to partnerships.
Both effectively avoid corporate tax rates, problems of compensa-
tion and salaries, and concede dividend avoidance. The corpora-

92 IRC § 1372(a).
93 IRC § 1372(e)(3).
94 IRC § 1373(b).
95 IRC § 1372(d)(3).
96 IRC § 1372(e)(1).
97 Note, A Tax Comparison of Limited Partnerships and Subchapter S, 43 Minn.
tion, however, requires accurate predictions of future profits to escape the high tax rates\textsuperscript{98} and changes in structure are more liable to be questioned than are those of a partnership.

Collapsible corporations are more of a problem than are collapsible partnerships. The collapsible partnership\textsuperscript{99} provisions only effect certain types of partnership assets, to wit: unrealized receivables and substantially appreciated inventory, and then only to a limited degree in certain instances.\textsuperscript{100} In real estate investment, the key is the definition of an unrealized receivable\textsuperscript{101} and of substantially appreciated inventory.\textsuperscript{102}

Unrealized receivables do not include rent or receivables resulting from the sale of property used in the trade or business; nor the right to receive payments for real estate sold where the proceeds are ordinary income (sold out of inventory).

Substantially appreciated inventory items do not include real estate, which is a capital asset. It only includes that which is inventory to the partnership or would have been inventory in the partners' hands, including stock of a collapsible corporation where the corporation is a partner.\textsuperscript{103}

The only problem in the area would be faced by the partner who is a real estate dealer.\textsuperscript{104} The fact that one partner is a dealer does not taint the property received by another partner.\textsuperscript{105} The dealer may segregate property by placing it in a partnership and claiming sales not in the regular course of his business.\textsuperscript{106} Capital gains would be realized as long as the property was not inventory.\textsuperscript{107}

Although the intent of the collapsible partnership provisions of the Code is to prevent the converting of ordinary income into

\textsuperscript{98} Bittker, \textit{Thin Capitalization: Some Current Questions}, 34 Taxes 830 (1956).
\textsuperscript{100} Unrealized receivables are not taxable if they were originally contributed by the receiving partner, or a retiring partner or his successor in interest; IRC § 736(b).
\textsuperscript{101} IRC § 751(c).
\textsuperscript{102} IRC § 751(d).
\textsuperscript{103} Katcher, \textit{Tax Problems incident to Acquisition of Real Estate}, 11 W. Res. L. Rev. 145 (1960).
\textsuperscript{104} IRC § 751(d)(2).
\textsuperscript{107} IRC § 731(a)(1).
capital gains, careful planning may enable the results to be modified, or at least delay the taxing of the ordinary income until desired by the partner.\textsuperscript{108}

\textbf{Subdivisions}

Subdivisions create a separate set of problems. A subdivision usually creates the status of a dealer in the developing entity\textsuperscript{109} with the exception in the instance when the subdivision is created to aid in liquidation of property.\textsuperscript{110}

The use of multiple corporations has been attempted to spread the potential profits broadly enough as to reduce the tax level and control the distribution of profits. This manner of attempted control has the inherent weakness of falling afoul of Section 269 of the Code, as well as other potential dangers. Where the subdivision is divided into areas under separate corporate control, but with substantially the same stockholders, the probability of disallowance is great. A more practical approach is the dividing of the various areas of development such as sales, construction, land development, water and sewerage, into separate corporations. In this manner the substantiation of business purpose is more readily available.

The individual owner of property, or the joint ownership of land has had some degree of relief from the arduous burdens of the Code. Congress, realizing the problem of the owner who is required to subdivide to liquidate, has approved a grant of relief.\textsuperscript{111} In order to qualify for these provisions, the owner or owners must show that they were not dealers in the year of sale, that they never held subdivision property, have owned the tract for more than five years, and have made no substantial improvements.\textsuperscript{112} The property must be owned during the requisite time by the present owner or members of his family, as defined by Section 267(c)(4) of the In-

\textsuperscript{108} Anderson, Tax Factors in Real Estate Operations (1960).
\textsuperscript{109} Palos Verdes Corp. v. United States, 201 F.2d 256 (9th Cir. 1954); see discussion note 108 supra at 269; see also Hausler, How to Handle Real Estate Transactions, P-H Tax Ideas \textsuperscript{17,001.1} (1963).
\textsuperscript{110} IRC § 1237.
\textsuperscript{112} IRC § 1237(a)(1)(2)(3).
ternal Revenue Code of 1954, or by a corporation controlled by the taxpayer or a partnership of which he is a member.\textsuperscript{113}

Relief may be had even if the property is improved where the property is held for a period of ten years,\textsuperscript{114} and buildings, water, sewerage, drainage and roads were placed upon the land as the only means of marketing the holdings.\textsuperscript{115}

The relief is intended to work in only the most extreme situation. The majority of subdivisions are created with a strong profit-making motive in mind. Marginal land is of little incentive in this situation, and it is most probable that only marginal land would qualify under this section.

Controlled development and sales is a solution to this problem, although a poor one, as the costs of acquisition and development require rapid sales to allow the realization of substantial profits. The group interested in the subdivision may be able to achieve their end by the control means of each party assuming the posture most favorable to himself and merging the effort in a partnership or corporation, thus allowing for some tax relief.

**Conclusion**

Analysis of the various modes of property ownership indicates that the interested party or parties may be able to achieve the major portion of their aims by careful projection of the problems which face the group and by planning prior to the acquisition of the real property. Problems of title ownership, limited liability, tax consequences, centralized management, voice in management, size of the group and many other factors must be carefully weighted one against the other before a decision may be made. Although the limitation of taxation is often a prime purpose of the group, it should not be the sole determining factor. Competent counsel can often team the demands of the group together to bring forth an adequate, tailored vehicle to protect the group, each member, their investment, and the ultimate success of the venture.

\begin{itemize}
  \item \textsuperscript{113} IRC § 1237(a)(2)(A).
  \item \textsuperscript{114} IRC § 1237(a)(3).
  \item \textsuperscript{115} See note 103 supra; and Hausler, note 109 supra.
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