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CHOICE OF ENTITIES FOR HOLDING REAL ESTATE: CORPORATIONS

LEONARD L. SILVERSTEIN*

It is always a great pleasure to come to Williamsburg, and particularly to combine a federal tax discussion with a setting—Colonial Williamsburg—which only the interaction of private philanthropic initiative and the federal tax system can provide. While we know that the latter is inevitable, let us hope that the former—lubrication through tax incentives of charitable instincts—will also remain an integral part of our social fabric.

As with so many aspects of American life, the pervasiveness of the federal tax laws intrudes upon the choice of legal entity in the conduct of real estate development. I propose to discuss these issues essentially from the standpoint of the entrepreneurial person who, often with the aid of passive investors (from here or abroad) plans to construct, operate and ultimately, to dispose of a real estate “development.” Such a development includes the production of single family homes, each to be owned by the occupant or, alternatively, the erection of a multi-unit highrise structure, to be owned by the developer as an apartment house, or the user as a condominium or cooperative. Also to be considered is the erection of office buildings and the construction of shopping centers.

In each of the foregoing situations, the entrepreneur seeks to insure that the start-up cost and, later, the cash and noncash operating expenses, such as the depreciation, become immediately available to offset the tax burden on income attributable to him from other sources until such time as the project itself becomes profitable. Inevitably, the entrepreneur must concern himself also with the tax effects of disposition either in a sale which he cannot refuse in today’s worldwide market for real estate or at death.

For most real estate developers, the choice of a corporation for any or all of the foregoing segments of business conditions may indeed not be a preferred one. Insulation from tort and contract claims may essentially be achieved *de facto* through the use of insurance with respect to the entrepreneur. Further, if passive investors contribute to the capital needs of the project, those persons can restrict the extent of their funds risk by becoming limited partners in a limited partnership. Indeed, the partnership, particularly the limited partnership as it now functions, successfully combines the essential insulation qualities respecting liabilities with flow-through attributes to the partners of losses for tax purposes. This can, in turn, be coupled with a capital gains capacity for both the entrepreneur and the investors at time of

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disposition.* Thus, the partnership would appear sufficiently adaptable to warrant the avoidance of the corporate vehicle in many instances. While this is indeed the case, there remains, nevertheless, certain important uses of both Subchapter S and ordinary corporations.

A. *Subchapter S Corporations*

A detailed description of the special attributes of this artificial creature of the Internal Revenue Code extends beyond the scope of this discussion. The principal ones—avoidance of double tax, as well as pass-through of corporate losses and investment credit—cause a Subchapter S to be a convenient vehicle in some instances, particularly in situations in which the entrepreneur desires insulation from legal liability and continuity of existence which only a corporation can provide. On the other hand, constraints which apply in operating in Subchapter S form—15 or fewer shareholders,* inability to pass-through losses in excess of equity investment,** and disqualification if passive income exceeds 20 percent of gross receipts,* among others—constrain the use of a Subchapter S corporation as a general rule for rental real property. Notwithstanding, the entrepreneur engaged in the business of constructing and selling single family residences may well find this form of legal entity to be a preferred vehicle. Use of a Subchapter S corporation enables the shareholders to be legally insulated from claims which might otherwise be made personally against them, permits the avoidance of double taxation and, particularly, enables the shareholders to choose a taxable year other than the calendar year,** thereby permitting a significant deferral of liability for tax. Because production and sale of single family residences, or condominiums, does not involve the generation of significant amounts of passive income, constraints in Subchapter S on the generation of passive income are not applicable. In summary, because Subchapter S permits limited flow through of losses, the use of the Subchapter S coupled with its capacity to choose taxable years, enables the entrepreneur to modulate the realization of income from one project with the generation of losses of another.

If, however, the activity of the Subchapter S company proliferates; that is, if it extends to the point where family members who may typi-

* "Virtually all real estate tax shelters are set up as limited partnerships. This permits the outside investors to share fully in the partnership tax deductions, while limiting their liability for any actual partnership losses. . . ." "Background Paper: Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives," Congressional Budget Office (May 1977) at 25-26.

* Code § 1371(a)(1). The limitation on the number of shareholders was increased from 10 to 15 by the Revenue Act of 1978. P.L. 95-600, § 341(a) (Nov. 6, 1978). Unless otherwise indicated, all references herein are to the Internal Revenue Code of 1954, as amended (The "Code").

** § 1374(c).

* § 1372(c)(5).

** § 441 Cf. Code § 706(b).

cally hold shares in the corporation find that income is being generated in such substantial quantities that it cannot be offset by losses from other sources, then consideration may be given to terminating the Subchapter S election, and conducting the home building business in ordinary corporate form.

B. *Ordinary Business Corporations*

It is appropriate at this point to consider—first with respect to the production and sale of single family homes—the use of an ordinary business corporation, as distinguished from a Subchapter S corporation, partnership or other form of entity. It is too well known to merit more than the briefest reference here to observe that unlike a Subchapter S corporation, an ordinary corporation may not deduct distributed earnings.* In consequence, the recipient shareholders are taxed at a second time upon their receipt. Although it is true that the combined federal income tax on distributed earnings received by a shareholder in a high bracket can exceed the maximum rate on individuals, other factors may nevertheless suggest that an ordinary business corporation constitutes an appropriate vehicle for single family home production and sales. Salaries, which must be reasonable but which can nevertheless be substantial are, of course, fully deductible, thus to that extent, a shareholder-employee resulting in a single individual level. Additionally, retirement arrangements can be entered into without the limitations on “owner-employees” which obtain in the case of Subchapter S corporations, or other forms of self-employed arrangements. While description of retirement plans is clearly beyond the scope of these remarks, it is sufficient here to note that these too may be substantial. These arrangements may be significant not only in avoiding the double taxation, but also in providing beneficial estate tax consequences. Most importantly, retained earnings, having borne only the lower corporate tax burden, are available for reinvestment in new land purchases and capital equipment. Or they may enable a corporation to diversify its activities. While corporate earnings cannot, of course, absorb shareholder-level losses, important loss offsets are available where the corporation has been made a part of an affiliated group by the entrepreneur.*

* This occurs in certain foreign countries, such as Germany.

* For example, if a home building entrepreneur operates in several diverse geographical locations, he can form a parent corporation with subsidiaries engaged in business in each of the locations and a separate subsidiary for management. Although multiple surtax exemptions are not, as before available to each of the corporations, investment credits or other tax offsets generated by the management company (for example, with respect to capital equipment which it may purchase) would be allocated within the affiliated group in accordance with the consolidated return regulations under section 1502. Moreover, if any of the geographically separated operations became unprofitable, its losses would be available to offset the profits from activities in a profitable area.

An ongoing ordinary corporation engaged in home building production as described above is available for a nontaxable merger with unrelated parties provided the various business tests enunciated in the reorganization provisions of the Code can be met. If the proposed amalgamation is conducted for normal business reasons, this can be accomplished without significant difficulty. Similarly, if the building corporation has subsidiaries which are also engaged in the active conduct of a trade or business, one or more of these subsidiaries may be "spun off" without tax to the shareholders provided the corporate separation provisions of section 355 of the Code are also observed. Finally, upon the death of any of the shareholders of the corporation, the shares of that person that are received by his estate—at least through 1979—will take a basis equal to the fair market value at the date of death (or the six months alternate valuation date) without any tax having been imposed upon the retained earnings.

C. Collapsible Corporations

There is, of course, a severe disability which attends the production and development of single-family homes by a corporate entity. Because that corporation is engaged in the "construction or production of property," a sale of corporate shares by any shareholder owning more than 5 percent* of its outstanding stock is exposed to taxation as ordinary income, rather than capital gain under Code § 341. This exposure is attributable to the fact that at any point in time of the normal life cycle of a home production corporation, there exists substantial unrealized depreciation (in its unsold land, lots or homes). So long as this condition persists at date of sale, a presumption arises that the corporation is a "collapsible" corporation, thus provoking ordinary income treatment.** Although several exceptions to this punitive ordinary income rule exists, the possibility of collapsible corporation characterization overhangs most potential cash (or cash equivalent) dispositions of shares of home building corporate entities. In some instances, however, exceptions can apply, and they are therefore worthy of note, even though the details of the collapsible corporation rules are too intricate for inclusion in these remarks. First, if the home building corporation has been owned by the same family group and has not changed its business for twenty years, the Service will apparently rule the corporation was not collapsible;* similarly, if a corporation's assets are sufficiently limited at date of sale (for example, if all that exists are retained earnings and a tract of land, more than one-third of which has been developed or sold), ordinary income treatment may be avoided.** Further, if the buyer is willing to purchase the corporate

* § 341(d)(1).

** § 341(c).

* Reg. § 1.341-5(c)(1)(i).

** Reg. § 1.341-5(c)(2).

shares and agree that the unrealized corporate level gain will always be ordinary income (that is, whether or not he liquidates the corporation immediately upon purchase of its shares), then the seller can be assured of capital gains upon disposition.*** This so-called "section 341(f)" election, while useful, often causes the buyer to reduce the purchase price in the negotiations for sale.

Despite the foregoing inhibitions, a corporate home building entity can prove useful if, in the case of substantial operations in an exuberant securities market, the seller desires a public offering of his shares. Because so many home production corporations are family owned and operated, requiring the personal attention of a principal shareholder, public offerings of realty companies of this category are somewhat rare, but they have occurred, and doubtless will continue to occur under appropriate market conditions.

D. Cooperative Housing Corporations; Condominiums and Homeowners Associations

Let us consider next the role which the corporate entity may play in connection with multi-unit residences, or office buildings. The corporate role here, again with very important exceptions, is quite limited. Thus, except with respect to Subchapter S, a corporation rarely possesses the capacity to pass through losses it has incurred during the start-up phase of construction and initial operation. On the other hand, the corporation may provide an ideal vehicle for purchasing an existing apartment house for conversion to condominium units or a cooperative.* The purchaser, for example, in the case of "condominium developer" can avail himself of a corporate entity to provide insulation from tort and contract liability as well as to capture a gain subject to lower corporate-level rates. Whether such a person would utilize ordinary business corporation or a Subchapter S corporation will, of course, depend upon his personal situation, including the existence of a corporate purchaser with existing internal losses and an interest in maintaining an ongoing corporate entity with the expectation of ownership until death or capital gains disposition. Alternately, he may consider the use of Subchapter S corporation for this purpose if his individual situation is such that his realizable losses from other projects can effectively offset income from the condominium development.

Unlike the typical condominium purchase and sale transactions, a cooperative arrangement presents a different circumstance which entails, by definition, the use of an ongoing corporation. Here the owners

*** §341(f)(1) and (2).

* See generally, M.B. Cowan, "Tax Reform on the Home Front: Cooperative Housing Corporations. Condominiums and Homeowners Associations," Vol. 5, No. 2 *J. of Real Estate Tax.* 101 (1978); and L. R. Kaster, "Co-Ops and Condominiums—The Sponsor's Viewpoint," 28 *N.Y.U. Ann. Inst. of Fed. Tax.* 99 (1970).

of the corporation are themselves the residents of the building which is the subject of the purchase (and/or construction). Because a special Code provision* permits the pass-through to the residents of personal deductions for interest and taxes, shareholders of a cooperative housing corporation (i.e., holders of proprietary leases on the residential units) can enjoy the benefits of individual home ownership with insulation from legal liabilities which would attend the partnership form. Moreover, although the law is not entirely clear, the depreciation deduction available to the cooperative offsets the possible income from payments which the residents make to the corporation to liquidate the mortgage loan.**

E. Rental Real Estate and Foreign Corporations

We return, finally, to the case of a passive investor in rental real estate, such as an office building or an apartment house. If it be assumed that such a person does not manage the operation of the building but simply receives rent, use of a Subchapter S corporation is not available.* Moreover, while income from the receipt of rents by an ordinary business corporation can be offset entirely or substantially, by deductions for depreciation, a corporate entity cannot, of course pass cash flow to a U.S. citizen or resident shareholder except upon payment of a tax either as a dividend, a capital distribution (taxable as a capital gain) or, depending upon the shareholder's other activities, as an ordinary income (collapsible corporation) distribution. Individual or partnership ownership, in contrast, enables an owner or partner to receive cash flow directly without payment of tax. Losses in excess of cash flow can also be applied as an offset to reduce taxes otherwise payable with respect to other income.** Upon disposition of the property, and assuming that the owner of the building is not a "dealer," capital gain is available.*** As in the case of a corporate holder, if the owner-partner owns the building at death, a step-up in basis is available during 1979, thus eliminating all gains with respect to depreciation (there being no redepreciation recapture at death and no income tax on the unrealized gain).

Notwithstanding the foregoing, circumstances can arise in which a U.S. citizen or resident may find it advantageous to incorporate rental real estate. Assume that such a person is a "dealer" in "real estate," i.e., he has sold land and conceivably some previously owned

* § 216.

** § 216(c).

* § 1372(e)(5).

** Except to the extent that gain is avoided at death, the "savings" are largely recaptured upon later disposition.

*** The amount of the gain may include the "negative basis" measured by the excess of the mortgage loan amount at date of disposition over the adjusted basis of the property, net of deductions for depreciation.

apartment houses. In this instance, while incorporation of the building would, in all likelihood, cause such building to be characterized as a collapsible corporation for the expiration of three years from the completion of construction of the building, the shareholder-owner may well be in a position to sell the stock, or after the passage of the three year period, to liquidate the corporation and obtain a capital gain. While questions arise if this activity occurs on a regular basis,* the possibility of incorporating rental real estate as a means of insulating it from dealership characterization by underscoring its investment nature should certainly be given consideration in specific situations.*

Finally, attention must be directed in the widespread interest which foreign persons are now exhibiting in investing in U.S. real estate as passive investors. Assume for this purpose that a nonresident purchases U.S. rental real estate under a net lease arrangement, so that third persons manage the building and that the nonresident simply is entitled to receive net rental payments periodically.** If there is no treaty between the country of residence of the foreign person and the United States, rental payments will be subject to a withholding tax of 30 percent of the gross amount of such rental payments without the allowance of any deductions.*** If the nonresident is a resident of a country which has a treaty with the United States or if he incorporates in a country which has such a treaty (and permits the utilization of the treaty by nonresident shareholders), the rental payment may be reduced to a lower rate, such as 15 percent. Additionally, whether by reason of a special election under the Internal Revenue Code,* or by reference to specific treaty provisions, such a nonresident person may elect to be taxed on the rents net of expenses. A sale by such a person, which occurs in a year in which the election is in effect, will, however, generate capital gain.**

Use of a corporation could be attractive under the foregoing circumstances, assuming that the owner is in a position to apply the tax

* See *Herman Katz* 19 T.C.M. 1035 (1960).

* If the majority of the corporate real estate is depreciable investment property not held out for sale to customers, section 341(d) prevents capital gain from being converted into ordinary income under the collapsible corporation rules, on the theory that in the absence of a corporation. The shareholder could have reported profit on the sale of the property as section 1231 gain. See *Ginsburg v. Comr.*, 33 T.C.M. 814 (1974).

** If the foreign corporation's activities are confined to the ownership of U.S. rental property subject to net leases, the service will generally not consider that such activities constitute a U.S. trade or business through a permanent establishment. See Rev. Rul. 73-522, 1973-2 C.B. 226. However, the management or sale of the foreign corporation's real estate may be deemed to constitute a trade or business in the U.S.

*** Section 881(a)(1). For this purpose, gross rentals include amounts paid by a lessee for such expenses and taxes and insurance.

* See sections 871 and 881.

** Section 871(b).

treaty between the U.S. and the Netherlands Antilles. Such an arrangement envisages the formation of a Netherlands Antilles corporation, which would conduct itself in such a manner that its corporate *bona fides* would be recognized (such as through the maintenance of an office in the Netherlands Antilles, the engagement of employees and other factors). That corporation, pursuant to the Netherlands Antilles-U.S. treaty, would be free of any U.S. withholding tax upon rental payments to the shareholders of the Antillean corporation. Moreover, and pursuant to the special terms of this treaty, dividend and interest payments made by the Antillean corporation to the foreign persons would themselves be free both of U.S. and Antillean withholding tax. The tax burden on the entire transaction would be derived from a small Antillean tax on the net rentals as received. As an ultimate benefit, the shares of such a corporation could be sold in a twelve month liquidation under section 337, if the corporation is not "collapsible." If the corporation is collapsible, the shares should be able to be sold directly to a purchaser prior to the liquidation of the company, again without any U.S. tax burden.*

Conclusion

The choice of a legal entity for the holding of real estate dramatically affects the tax burden of the owners. While in some cases, as the foregoing seems to demonstrate, the corporate form combine favorable tax attributes with the many other benefits derived from corporate ownership and in other situations, particularly with respect to passive rentals, noncorporate ownership may be much more desirable. In summary, a potential owner or developer of real estate must be particularly selective in choosing the legal form in which the property is to be owned and operated.

* It may be advantageous to set up a two-tier corporate structure in this situation, placing the income-producing assets (that are engaged in a U.S. trade or business) in a subsidiary corporation, the stock of which is owned by the parent Netherlands Antilles corporation. Again, the separate *bona fide* existence of each corporation must be specially noted.

I.

CORPORATIONS IN THE REAL ESTATE BUSINESS

A. Introduction.

The corporate form of ownership of real estate has long been considered by tax analysts to be an unsatisfactory choice, in comparison to the advantages of ownership by a partnership or a real estate investment trust.* Although these analysts admit that there are many non-tax advantages stemming from the fact that a corporation is a legal entity distinct from its shareholders, in most cases these legal advantages are outweighed by such tax disadvantages as double taxation of income, and the unavailability to corporate shareholders of deductible business losses.**

The disadvantages do not always outweigh the advantages of corporate ownership of real estate, however. As the outline below shows, numerous examples can be found of different types of corporations that are currently being used to acquire, hold and manage various kinds of real property.

B. Kinds of Real Estate Being Developed by Corporations.

1. Residential development—single family homes
2. Condominium Construction
3. Apartment-to-Condominium Conversion
4. Office Building Construction
5. Shopping Center Development
6. Farm land

C. Types of Corporations Holding Real Estate.

1. Public corporations*
2. Closely-held regular corporations
3. Subchapter S corporations
4. Nominee or straw corporations
5. Cooperative housing corporations
6. Homeowners' associations
7. Foreign corporations

* "Virtually all real estate tax shelters are set up as limited partnerships. This permits the outside investors to share fully in the partnership tax deductions, while limiting their liability for any actual partnership losses . . ." "Background Paper: Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives," Congressional Budget Office (May 1977) at 25-26.

** See "How to Choose a Form of Ownership for Real Estate: Explanation and Practical Guide," Real Estate Review Portfolio No. 14 (1977), Ch. II "Partnership—a Favored Form of Real Estate Ownership." See also Aronson, Kurtz and Kronovet, "Advantages and Tax Advantages of Various Ways of Holding Real Estate, 28th N.Y.U. Ann. Inst. on Fed. Tax 145 (1970).

* See "Real Estate Acquisitions New Turf for Giant Firms," Washington Post, Oct. 28, 1978 at E1.

II.

NON-TAX CONSEQUENCES OF CORPORATE OWNERSHIP
OF REAL ESTATEA. *Benefits.*

1. The four factors that, under the *Kintner* test,** define a "corporation."
 - a) limitation of shareholders' liability
 - b) continuity of life
 - c) free transferability of shareholders' interests
 - d) centralization of management
2. Facility in Financial Dealings
 - a) avoidance of usury statutes***
 - b) availability of new capital through sale of shares, bonds, debentures or other securities
 - c) creditworthiness superior to that of shareholders. [Note that shares of a closely-held corporation may even be used as collateral for a corporate loan.]
3. Simplification of Certain Legal Processes
 - a) ease of conveyancing, when there are many owners
 - b) preservation of anonymity of ownership for corporate shareholders
 - c) ability to sue and be sued in corporate name

B. *Detriments*

1. costs of formation
2. realization that many of the non-tax benefits listed above are also available to partnerships, entities that are able to avoid the tax detriments listed below

** I.R.C. Regs. § 301.7701-2.

*** *Jones v. Com'r.*, T.C. Memo 1978-446 (11/7/78).

III.

TAX CONSEQUENCES OF CORPORATE OWNERSHIP OF
REAL ESTATE

A. In General

1. Benefits.

- a) *Lower Corporate tax rates.* New graduated corporate tax rates are lower than rates applicable to high-bracket individual taxpayers under the 1978 Revenue Act. For years after 1978, the corporate tax rates are as follows:

<i>Rate</i>	<i>Bracket</i>
17%	up to \$25,000
20%	\$25,000- 50,000
30%	\$50,000- 75,000
40%	\$75,000-100,000
46%	over \$100,000

- b) *Possible Recognition of Capital Gain.* Capital gain, not ordinary income, will be realized on liquidation of the corporation, or on a sale of stock by the shareholders at prices reflecting accumulated earnings.
- c) *Fringe Benefits for Corporate Principals.*
- i) Salary deductible by corporation as business expense. [NOTE: Salaries can account for a substantial part of the corporation's income. So long as the salaries are reasonable, these business deductions can be a useful means of avoiding the double tax. If the salaries are deemed unreasonable, however, they will not be deductible by the corporation and may even be taxable at ordinary income rates as dividends to the shareholder-employee.]
 - ii) compensation subject to withholding and social security taxes
 - iii) tax-favored retirement and pension plans*
 - iv) death benefits up to maximum of \$5000 can be received tax-free by beneficiaries of a shareholder-employee**
- d) *Avoidance of § 1250 Recapture.* The shareholder who sells stock avoids the recapture that would otherwise have resulted if he had sold outright any real estate that had been depreciated at rates more rapid than straightline.***

* Code § 401 et seq.

** Code § 101(b).

*** Code § 1250(a) and (b).

- e) *Advantage for Real Estate Dealers.* Incorporation is an ideal means for real estate dealers who wish to segregate their investment real estate from other real property. The incorporation of a dealer's investment property, followed (not immediately) by sale of the corporation's stock should insure that the dealer will realize capital gains, not ordinary income, on the sale.
- f) *No Restrictions on Use of Fiscal Year.* In contrast to the rules applicable to partnerships, a corporation can select any fiscal year it desires.*

2. Detriments.

- a) *No pass-through of losses or deductions.* Business losses, deductions for depreciation, interest and property taxes, and investment credit must be claimed by the corporation, not its shareholders.
- b) *Double taxation.* There is a double tax on corporate income when dividends are paid to shareholders. [Note: Possible ways for a corporation to avoid this double tax are to take deductions for reasonable salaries to shareholder-employees, or to accumulate income (within limits** so as to avoid any accumulated earnings tax) until the corporation is liquidated or sold.
- c) *Collapsible Corporation.* If the principle shareholders sell their shares or liquidate the corporation before the real estate has been held by the corporation for over three years, the collapsible corporation rules*** would convert capital gain on the sale into ordinary income* [NOTE: these rules can be avoided if the majority of the corporate real estate was depreciable investment property not held out for sale to customers, since Code §341(d) prevents capital gain from being converted into ordinary income if, in the absence of a corporation, the shareholders could have reported profit on the sale of the property as § 1231 gain.**]
- d) *Accumulated earnings tax.* A penalty tax is imposed under §§ 531-537 on income accumulated beyond certain limits,

* Code § 441; cf. § 706(b).

** Code § 531.

*** Code § 341.

* *Manassas Airport Industrial Park*, 66 T.C. 566 (1970), aff'd 77-2 U.S.T.C. ¶ 9497 (4th Cir.) (Taxpayer held to be collapsible).

** *Ginsburg v. Com'r.*, 33 T.C.M. 814 (1974).

if the purpose of the accumulation is to avoid income tax with respect to shareholders.***

- e) *Personal holding company tax.* If the corporation is used to produce passive income beyond certain percentage limits,**** it would be deemed to be a personal holding company, subject to a 70% penalty tax on its undistributed personal holding company income under § 541-547.
- f) *State and local taxes.* Corporations are also subject to various state and local taxes which, of course, are deductible from federal income taxes.

B. Subchapter S Corporations.

1. Benefits.

- a) *Flow-through of losses, deductions, and investment credit.* While enjoying the benefits of limited liability, subchapter S corporation shareholders also benefit from tax advantages offered by the partnership form. [NOTE, however, that there are limitations imposed upon shareholders' deductions, e.g., if long-term capital gain exceeds short-term capital loss by more than \$25,000,* or if net operating loss deductions exceed the adjusted basis of the shareholder's interest.**
- b) *Income from property management not subject to the 20% gross receipts test.* A Subchapter S management corporation that derives income from hotel operations, or parking lots can insulate a real estate investor from personal liability, without subjecting him to any danger of termination of the sub-

*** *F. H. Ayres & Son v. Com'r.*, 13 T.C.M. 952 (1954) (retention of \$100,000 surplus by taxpayer engaged in business of developing vacant lots held to be a reasonable accumulation to meet developmental needs). See also *House Beautiful Homes, Inc.*, 26 T.C.M. 261 (1967) *aff'd* 405 F.2d 61 (10th Cir. 1969). Cf. *Atlantic Properties* 519 F.2d 1233 (1st Cir. 1975) (accumulation held to be unreasonable).

**** See *Parkside, Inc. and Beaconcrest, Inc., v. Com'r.*, 78-1 U.S.T.C. ¶ 9147 (9th Cir., 1977) (reversing Tax Court, to hold that duplex homes sold by the corporations were held for sale to customers in the ordinary course of business and that certain payments received under sales contracts constituted "rents" excluded from personal holding company income under § 543(b)(3). These payments constituted more than 50% of the taxpayers' ordinary gross income). And see *Webster Corp v. Com'r.*, 240 F.2d 164. (2d Cir. 1957) (where taxpayer corporations owned farms that were partly managed by a farm management concern, the income received by the corporations was not rent, or personal holding company income, but income from their own use of land.)

* Code § 1378(b).

** Code § 1374(c).

chapter S election, since these types of rental income are not considered to be passive.*

2. Detriments.

- a) *20% gross receipts test.* The subchapter S election is terminated if more than 20% of the corporation's gross income is derived from rents or other passive income.** This limitation can present significant problems after a real estate development project passes construction stages.
- b) *Tax on certain capital gains.* An additional tax is imposed on the electing small business corporation if net capital gain exceeds \$25,000 and exceeds 50% of the corporation's taxable income for the year, or if the taxable income of the corporation exceeds \$25,000.***
- c) *Excess foreign income.* The Subchapter S election is terminated if the corporation derives over 80% of its income from sources outside the United States.****

C. *Nominee or Straw Corporations.*

1. *Benefits—Disregard of Corporate Form.* Shareholders form straw corporations in order to take advantage of the various non-tax benefits of corporate ownership, [see II.A., *supra*], while relying on the presumption that the corporation will be disregarded for tax purposes, since it is merely the alter-ego of the beneficial owners, and engages in no significant business activity.*
2. *Detriments—Recognition for Tax Purposes.* There is, however, a real danger that the corporation will not be recognized as a separate taxable entity, in which case the shareholders must also bear the burden of the tax detriments listed above. [II.A.(2). *supra*].**

* Regs. § 1.1372-4(b)(5)(vi). *But see Bramlette Building Corp., Inc. v. Com'r.*, 424 F.2d 751 (5th Cir. 1970) (election terminated, because significant services were not performed by Sub S corporation that furnished elevator operators, maintenance men and night watchman for an office building, and leased space to various small service businesses).

** Code § 1372(e)(5).

*** Code § 1378.

**** Code § 1372(e)(4).

† *Bolger v. Com'r.*, 59 T.C. 760 (1973) *acq.*, 76.2 C.B. 1. See Leg. Recommendation No. 1, ABA Committee on Real Estate Tax Problems, Sept. 15, 1978, which proposes to amend the code "to enable corporations in certain specified circumstances to elect to be treated as mere nominees or agents of their shareholders for tax purposes." See also M. Kalb and S.B. Lapidus, "Nominee Corporations: Legislation is the Only Solution," Vol. 5, No. 2 *J. of Real Estate Tax.*, 142 (Winter, 1978).

** *Moline Properties v. U.S.*, 319 U.S. 436 (1943); *Klausner v. Com'r.*, T.C. Memo 1978-405 (Oct. 11, 1978) and *Jones v. Com'r.*, T.C. Memo 1978-446 (Nov. 7, 1978).

D. *Cooperative Housing Corporations.*

1. Benefits*

- a) *Allowance of deductions to tenants.* The principal purpose of Code section 216 is to allow tenant-stockholders to deduct proportional shares of real estate taxes, mortgage interest, and in some cases, depreciation, on the same basis as taxpayers who own their own homes.
- b) *Allowance of certain deductions to corporation.* The cooperative corporation is specifically permitted to deduct depreciation on its improvements, regardless of the fact that tenant-stockholders may be deducting the identical depreciation.**
- c) *Partial corporate ownership of building permitted.* Note that there is no requirement that a cooperative housing corporation must own an entire building in order to meet the definitional requirements of § 216(b)(1).***

2. Detriments

- a) *No Code provision covers tax liability of the corporation.* Due to a lack of Code guidelines, it remains difficult to determine whether a corporation has satisfied all of the statutory requirements, or, if it has, what its tax liability will be.****

E. *Condominium and Homeowners Associations.*

1. Benefits

- a) *Partial tax exemption.* An association meeting the statutory definition may elect to be treated as a tax-exempt organization with respect to its "exempt function income," which includes membership dues, fees and assessments.
- b) *\$100 exemption.* Section 528 also provides a \$100 deduction against the association's income from investments or commercial rents, so that associations with minimal taxable income need pay no tax.*

* See generally M.B. Cowan, "Tax Reform on the Home Front: Cooperative Housing Corporations, Condominiums and Homeowners Associations," Vol. 5, No. 2 *J. of Real Estate Tax.* 101 (Winter, 1978). And see L.R. Kaster, "Co-ops and Condominiums—the Sponsor's Viewpoint, 28th *N.Y.U. Ann. Inst. of Fed. Tax.* 99 (1970).

** Code §216(c).

*** Rev. Rul. 78-31, 1978-4 I.R.B. 8.

**** See Cowan, "Tax Reform," *supra*, Vol. 5 No. 4 *J. of Real Estate Tax.* at 102. And see, e.g., Letter Ruling 7823054 (March 13, 1978), (refusing to rule on whether the corporation's gains on the sale of condominium units constitute capital gain or ordinary income).

* Note that a return apparently must be filed even if the association pays no tax, in order to preserve the § 528 election. S. Rept. No. 938, 94th Cong., 2nd Sess. 398, n. 4.

2. Detriments**
 - a) *No net operating loss deduction.*
 - b) *Loss of surtax and exemption.*
 - c) *Loss of 85% dividend deduction under § 243, and of deduction for partially tax-exempt interest under § 242.*
 - d) *Substitution of \$100 specific deduction for \$1000 exemption that might have been available under §512(b)(12)*
 - e) *90% expenditure restriction.* Under § 528(c)(e)(C), 90% of the organization's expenditures must be attributable to association property.
 - f) *60% Gross Income requirement.* Under § 528(c)(k)(B), 60% of the organization's gross income must consist of dues, fees, or assessments from resident-owners.
 - g) *No inurement of earnings.* Under § 528(c)(1)(D), the election is not available if any net earnings inure to the benefit of any individual shareholder.
 - h) *Numerous interpretation difficulties.* In general, it has been observed that "section 528 has raised many more questions than it answers, and it is likely to be productive of more litigation and confusion than would have arisen in its absence."*

F. *Foreign Corporations.*

1. If U.S. real estate is held by a foreign corporation not engaged in trade or business in the U.S., the foreign corporation will be subject to a flat tax of 30% on the gross rentals received, without allowance for any offsetting deductions.** This tax will be collected by withholding at the source.*** However, there will be no tax on the gains realized upon the sale of the real property.****
2. If the foreign corporation is engaged in a trade or business within the U.S. (whether through its real estate activities or otherwise), it will be taxed at U.S. corporate rates on its net rental income and capital gains.*****
3. If the foreign corporation's activities are confined solely to the ownership of U.S. rental property subject to net leases, the Service will generally consider such activities as not engaging in trade or business in the U.S. However, any further activities in connection with the management or sale of the foreign corporation's real estate may constitute a trade or business in the U.S.

** See Cowan, "Tax Reform," Vol. 5 No. 2 *J. of Real Estate Tax.* 130-132.

* *Id.* at 141. See generally pp. 132-141.

** Section 881(a)(1). For this purpose, gross rentals will include amounts paid by a lessee under a net lease for, e.g., taxes, insurance, etc.

*** Section 1442(a).

**** *Cf.* Regs. § 1.1441.

***** Section 882(a)(1).