Appendix 8B

General Counsel Memorandum 34613—General Counsel's Analysis of Depreciation Deduction for a Cooperative or Condominium Association and Clarification of Revenue Ruling 70-604

Cross Reference Data

Topical

Assessments
Depreciation deduction
Excess member income
Form 1120
Rollover of income

Citation

IRC Section—277—2F
Regulations Section—1.277-1—5F
Revenue Ruling—70-604—6H
Private Letter Ruling—7924005—7B
Other Ruling—98ARD 176-4, FSA 1992-0208-1—10H

Summary

GCM 34613 discusses the depreciation deduction for the building and related equipment of cooperative housing corporations.
- **The depreciation deduction is denied to cooperative housing corporations due to their insufficient economic interest in the buildings and because they do not hold the buildings for use in a trade or business or for production of income.**
- **This denial was subsequently reversed by the 1976 Tax Reform Act and by Rev. Rul. 90-36.**

Caution: The authors have omitted certain portions of this GCM that, in the authors' opinion, are not relevant to homeowners' associations. The deleted portions are denoted by * * * . Also, see Note [a] for a discussion of the 1976 Tax Reform Act, which supersedes the provisions of GCM 34613 that deny depreciation deductions to cooperative housing corporations.

General Counsel's Analysis of Depreciation Deduction for a Cooperative or Condominium Association and Clarification of Revenue Ruling 70-604

General Counsel's Memorandum, GCM 34613
Date Numbered: September 16, 1971

Internal Control Number:	CC:I:I-2922 Br4:RHH 0167.00-00 0167.01-00 0167.14-00 0216.00-00

HAROLD T. SWARTZ
Assistant Commissioner (Technical)
Attention: Director, Income Tax Division

In re: . . .

This is in response to your memorandum (T:I:C:2:2) dated December 22, 1967, forwarding to this office for our concurrence a proposed memorandum of advice to the Director, Appellate Division in the above-named case. This is also in response to a request for further information on the legislative history of section 216(c) made by representatives of the Income Tax Division to representatives of the Interpretative Division at a reconciliation meeting held on February 23, 1971.

ISSUES

(1) Whether a cooperative housing corporation is entitled to a depreciation deduction for the building and related equipment.

(2) Whether Regs. 1.216-2(b)(i) and the legislative history of section 216(c) reflect a Congressional intent to permit cooperative housing corporations to depreciate their buildings.

(3) If a cooperative housing corporation takes a depreciation deduction whether section 216(b)(1)(C) would require the cooperative to assess its tenant-stockholders for the amount of the depreciation deduction.

CONCLUSIONS

(1) It is our opinion that a cooperative housing corporation is not entitled to a deduction for depreciation on the building and related equipment.

(2) It is our opinion that neither Regs. 1.216-2(b)(i) nor the legislative history of section 216(c) recognize that a cooperative housing corporation may take a depreciation deduction on its building.

(3) It is our opinion that if the cooperative housing corporation took a depreciation deduction on its building, section 216(b)(1)(C) would require the cooperative to assess its tenant-stockholders the amount of the depreciation deduction in order to retain its status under section 216(b)(1) as a "cooperative housing corporation."

FACTS

In your memorandum (T:I:C:2:2) dated December 22, 1967 you requested our opinion on proposed technical advice to be given to the Director, Appellate Division in . . . . It was the position of the proposed technical advice that a cooperative housing corporation is entitled to a depreciation deduction because it is the owner of the building and is engaged in the trade or business of supplying its tenant-shareholders with living accommodations at the lowest possible cost. To hold otherwise would mean that all "nonprofit" cooperatives could never be entitled to a depreciation deduction.

In a proposed G.C.M. this office took the position that to the extent a cooperative corporation's property is held for the personal use of its tenant-shareholders, it cannot be considered to be held for use in a trade or business or for the production of income. Therefore, the building is not subject to a depreciation deduction.

A conference was held on June 16, 1969 to discuss the proposed G.C.M. While initial agreement was reached the G.C.M. was held pending final approval of the Income Tax Division. Final approval was not given.

This office reconsidered the position of the proposed G.C.M. and while we did not change our answer we offered a proposed solution to the policy considerations that had been raised. It is the position of the Income Tax Division that as a matter of policy housing cooperatives should not be taxed on their excess assessments as provided in Rev. Rul. 56-225, C.B. 1956-1, 58. We recommended in a proposed G.C.M. a method whereby a cooperative housing corporation could avoid tax on its excess assessments yet still retain 80 percent of the excess assessments in cash. The cooperative could accomplish this through qualified written notices of allocation issued in accordance with the cooperative provisions of Subchapter T (sections 1381–1388).

This solution was presented at a position meeting held between representatives of this office and the Office of the Assistant Commissioner (Technical) on July 21, 1970. The meeting was held to consider . . . and a second case . . . , I-3403. The principle issue discussed was whether unexpended funds remaining in the treasury of a condominium at the end of its taxable year constituted gross income to that corporation. The Income Tax Division rejected the Subchapter T paper allocation solution to the treatment of the excess monies as being too complicated and impractical. It was decided that a revenue ruling would be drafted, with the assistance of this office, in which the stockholders would get together at the end of the year to decide whether to return the excess funds or apply them to next year's [b] assessments. If this were done the money would not be includible in the condominium's taxable income.

G.C.M. 34326, . . . , I-3403, (July 31, 1970) was issued as a result of this meeting. G.C.M. 34326 states that it was decided at the meeting, in addition to the decision on the drafting of a proposed revenue ruling, that a cooperative housing corporation is not entitled to a depreciation deduction and that the proposed G.C.M. in . . . would be held pending modification due to the decision in *Bear Valley Mutual Water Co. v. Riddell*, 283 F. Supp. 949 (1968), aff'd 70-2 USTC P9551.

Without further consideration by this office **the revenue ruling contemplated at the July 21, 1970 meeting was issued as Rev. Rul. 70-604, C.B. 1970-2, 9. It held that excess assessments of a condominium corporation over and above the amounts used for the operation of condominium property that are either returned to the stockholder-owners or applied to the *following year's* [c] *assessments are not gross income to the corporation. On January 4, 1971 a meeting was held between representatives of our office and the Income Tax Division. At this meeting the representatives of the Income Tax Division agreed to modify Rev. Rul. 70-604 to read "taxable income" rather than "gross income." This modification was made by Announcement 71-11, I.R.B.***

1971-3, 44. Representatives of the Income Tax Division stated, however, that it was their understanding that no agreement was in fact reached on the issue whether a cooperative housing corporation can take a depreciation deduction.

On October 8, 1970 the Interpretative Division received a request from the Tax Court Litigation Division in the case of . . . on whether a cooperative housing corporation is entitled to a depreciation deduction on the building and related equipment. In O.M. 17252, . . . , I-3915, (Jan. 29, 1971) the Interpretative Division took the position that a cooperative housing corporation was not entitled to a depreciation deduction. The rationale for the disallowance of the depreciation deduction was different from that used in the original proposed G.C.M. in . . . and answered the questions that had caused the concern of the Income Tax Division. A copy of O.M. 17252 was forwarded to your office as an attachment to G.C.M. 34413, . . . , I-3915 (Jan. 29, 1971) in which we requested a reconciliation conference on the depreciation issue. A reconciliation conference was held on February 23, 1971. It was the opinion of the Income Tax Division that if the Service were going to tax cooperatives' excess assessments we had to permit them to take a depreciation deduction. The question was also raised whether section 216(c) and Regs. 1.216-2(b)(i) recognize that a cooperative housing corporation may depreciate its building.

A new proposed G.C.M. was submitted answering the questions raised at the February 23, 1971 meeting and a reconciliation conference held on August 31, 1971 between representatives of the Income Tax Division and the Interpretative Division. It was agreed only that the issue be considered at a higher level. On September 1, 1971, the Interpretative Division was informed by Associate Chief Counsel Richard M. Hahn that agreement had been reached between the Chief Counsel's Office and the Office of the Assistant Commissioner (Technical) and that a G.C.M. be issued and forwarded to the Income Tax Division on the depreciation question . . . , has been tried and fully briefed and is pending decision in the . . . .

The following analysis consists of the pertinent parts of all prior proposed G.C.M.s on the issue whether a cooperative housing corporation is entitled to a depreciation deduction.

ANALYSIS

(1) **Depreciation Deduction**—It is the position of the proposed technical advice that a cooperative housing corporation is entitled to a depreciation deduction because it is the owner of the building and is engaged in the trade or business of supplying its tenant-stockholders with living accommodations at the lowest possible cost. To hold otherwise would mean that all "nonprofit" cooperatives could never be entitled to a depreciation deduction.

It is the position of this office that a cooperative housing corporation is not entitled to a depreciation deduction on the building, first because it does not have a sufficient economic interest in the building to entitle it to a depreciation deduction, and second because it does not hold the building for use in a trade or business or for the production of income for purposes of section 167(a).

This position can best be understood if we first examine the reasons why cooperative housing corporations seek depreciation deductions and why these deductions have become an issue. First, a cooperative housing corporation may have unexpended money remaining at the end of the year which is not needed for the maintenance of the apartments. **Through the use of the depreciation deduction the cooperative is able to retain the excess of the assessments collected over the actual expenses paid and thus avoid taxation of such excess** under the rule stated in Rev. Rul. 56-225. Second, a cooperative housing corporation may have outside nonmember income from investments or the rental of commercial units in the building. Assuming that the assessments of the member equalled the expenditures for the maintenance of the building and the grounds, this outside income would clearly show up on the return as income subject to tax. Thus, **if the depreciation deduction were available, a cooperative could cancel out this outside income item with the offsetting depreciation deduction.** See *Bear Valley Mutual Water Co. v. Riddell* 283 F. Supp. 949 (1968), aff'd 70-2 USTC . . . P9551.

We understand why you believe it is desirable not to tax housing cooperatives on their excess assessments. It is our opinion that since there are at least two methods by which the housing cooperatives can avoid taxation of their excess assessments that the depreciation deduction should not be allowed solely for this purpose. First, housing cooperatives could easily qualify for taxation under Subchapter T. Section 1382(b) of Subchapter T provides that in determining the taxable income of a cooperative there shall not be taken into account amounts paid "as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property . . . . Section 1388(c) provides that a qualified written notice of allocation does not include any written notice of allocation which is paid as part of a patronage dividend unless 20 percent or more of the amount of such patronage dividend is paid in money or by qualified check. These provisions make it possible for cooperative housing corporations not only to avoid taxation of the excess assessments through the payment of patronage dividends, but enable them to pay the patronage dividends using only 20 percent cash with the remainder in "qualified paper." Thus, 80 percent of the excess assessments can be retained in cash for future expenses. Moreover, the patronage dividends to the tenant-stockholders would not constitute income to them under the rule of section 1385(b)(2).

The second way a cooperative housing corporation can avoid taxation of excess assessments is to use the procedure set forth in Rev. Rul. 70-604, C.B. 1970-2, 9. While the ruling deals with a condominium, it is our opinion that the procedure is equally applicable to a housing cooperative. Rev. Rul. 70-604 states that excess assessments by a condominium management corporation, over and above the amount used for the operation of condominium property, that are returned to the stockholder-owners or applied to the *following year's* [c] assessments are not taxable income to the corporation.

The second reason why housing cooperatives seek the depreciation deduction, to offset outside income, may be unavailable to them for the taxable years beginning after December 31, 1970. As to such years, **Section 277 precludes the use of outside nonmember income to offset the expense of supplying goods and services to the members. While section 277 may prevent future abuses in the subsidizing of member services with outside income, its applicability is not assured.** We do not think that the Service should rely on a provision such as section 277 as a panacea for the outside income problem so that housing cooperatives can use the depreciation deduction as an offset to excess assessments. Therefore, we should consider whether a cooperative housing corporation is entitled to a depreciation deduction on the building and related equipment.

Our first reason for denying cooperative housing corporations depreciation deductions is the incompatibility of the purpose and economic structure of a cooperative housing corporation and the rationale for the depreciation deduction. In . . . the developer could have chosen one of two different methods of marketing the apartments. He could have marketed the units through a condominium corporation or, as he did, through a cooperative housing corporation. These are two different methods of accomplishing similar results. In a condominium corporation each of the members holds title to his individual unit. Each member pays the real estate taxes and makes whatever financial arrangements he chooses to finance the acquisition of his apartment whether it be from his own financial resources or through a mortgage. **The condominium**

holds title to the common areas and assumes the responsibility of maintaining the common elements of the buildings and grounds. For this management service the members are assessed. The condominium, however, has no economic interest in the units of the members which would afford the corporation a depreciation deduction. The members themselves may not depreciate the units they occupy for the same reason that a homeowner is precluded from depreciating his residence. [a] Section 1.167(a)-2 of the regulations provides in pertinent part that:

> **no deduction for depreciation shall be allowed . . . on a building used by the taxpayer solely as his residence. . . .**

In a cooperative housing corporation, as defined in section 216(b)(1), each tenant-stockholder, instead of owning his individual apartment, must be entitled "solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation." In addition, section 216(b)(2) requires that such tenant-stockholder's stock must be fully paid-up in an amount not less than an amount . . . bearing a reasonable relationship to the portion of the value of the corporation's equity in the houses or apartment building and the land on which situated which is attributable to the house or apartment which such individual is entitled to occupy.

Since title to the building is in the cooperative and since each apartment is not considered a separate piece of real estate the cooperative must pay the real estate taxes and make the mortgage payments. Because Congress recognized that each member of the cooperative pays his pro rata share of the real estate taxes and mortgage interest through payments made to the housing cooperative it adopted section 216 to allow the pass through of these payments to the members. The corporation is merely holding title to the property in the capacity of a custodian for the personal use of its tenant-stockholders.

Section 216(c) allows a tenant-stockholder to depreciate his investment in his unit to the extent it is employed in a trade or business or for the production of income. In so doing, Congress recognized that the tenant-stockholder's right of occupancy constituted "a proprietary lease or right of tenancy." Since the tenant-stockholder's equity in the corporation must be equal to the corporation's equity in the unit for which the tenant-stockholder has a proprietary (ownership) lease, the corporation is not allowed to have any independent equity interest in the unit. Thus, the full equity, including the value of the land, must be paid for and held by way of a proprietary lease by the tenant-stockholder. Under these circumstances, it is clear that for a cooperative housing corporation qualifying under section 216 it does not and may not have an independent depreciable interest in property that has been sold to tenant-stockholders within the meaning of 216(b).

Thus, when viewed in this narrow context, the rights of a tenant-stockholder in a cooperative housing corporation are little different from those of the owner of a condominium unit in a condominium housing corporation. While the condominium owner owns direct legal title of his own unit, the cooperative housing tenant-stockholder clearly owns full beneficial enjoyment and title of his unit with the cooperative housing corporation holding bare legal title for management purposes and for the convenience of the tenant-stockholder. Both the condominium owner and the tenant-stockholder of a cooperative housing corporation may be dispossessed if they fail to make the required capital payments essential to carry and complete their capital investment in their particular unit. When viewed in this light, both a condominium and a cooperative housing corporation are merely legal techniques or formats to accomplish substantially the same end, the difference lying mainly in their form rather than in their real substance.

In these circumstances, it would be incompatible with the rationale for the allowance of the depreciation deduction to permit the housing cooperative to depreciate a building in which it has no substantial economic interest. In a typical trade or business conducted by corporations generally, the business entity obtains its income from goods or services supplied to persons other than its own shareholders. Against this gross income the business entity may offset ordinary and necessary business expenses and depreciation deductions on its property used in its trade or business to arrive at its taxable income. The amounts taken in depreciation represent a type of sinking fund which will enable the business entity to replace the depreciated property.

In *United States v. Ludey*, 274 U.S. 295 (1927) the Supreme Court concluded:

> The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction during the year of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sum set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold.

The depreciation deduction protects the taxpayer against loss of its capital. *Massey Motors v. United States*, 364 U.S. 92, 101 (1960). Consistent with this purpose is an establish principle that even though a taxpayer owns property that depreciates, it is not entitled to a depreciation deduction unless it suffers an economic loss as a result of the depreciation of the property. *Helvering v. Lazarus & Co.*, 308 U.S. 252 (1939); *Robert L. Hunter*, 46 T.C. 477, 490 (1966). The usual business entity suffers economic loss from the depreciation of the property which it uses in its trade or business because it is under an obligation to replace such property when it is exhausted.

In a cooperative housing corporation of the kind described in section 216(b)(1), at least 80% of its gross income must come from member assessments. See section 216(b)(1)(D). Under the lease, in the instant case, which is typical of most if not all housing cooperative corporations, the tenant-shareholder is assessed an amount which will cover salaries, common utilities, maintenance expenses, real estate taxes, mortgage payments, insurance and other miscellaneous expenses. There is no provision for assessments to replace the building. The members of the cooperative, as in the case of home owners generally, who purchase their residences with borrowed funds, are making regular principal payments in discharge of the indebtedness. The members are clearly not paying any amounts to the cooperative housing corporation for the replacement of the apartment building, for to do so would be tantamount to purchasing their residence twice. Therefore, just as a homeowner does not set up a fund to replace his house when it is worn out, so too a cooperative housing corporation has no duty to set up a fund to replace the apartment building when it is exhausted.

By its very nature and organization the cooperative housing corporation is not provided with the means to protect the capital of its tenant-shareholders. Thus, the tenant-shareholders themselves have in fact assumed the risk of loss through depreciation of the apartment building. Since the corporation has no such loss to protect against it is not entitled to the depreciation deduction.

A second reason for denying the depreciation deduction is that the cooperative holds title to the apartment building solely for the personal purposes of its tenant-stockholders rather than in a trade or business or for the production of income. See O.M. 15756, . . . , I-2501, (July 31, 1967).

Section 167(a) provides:

There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in a trade or business, or (2) of property held for the production of income.

We stated in O.M. 15756, citing . . . , 275 F.2d 578 (7th Cir. 1960) that:

. . . a taxpayer is not entitled to a depreciation deduction on property "to the extent that it is devoted to personal purposes, whether those purposes are personal benefits to the stockholders of a corporate taxpayer or whether they are personal benefits to an individual who is the taxpayer." To the extent that the property is devoted to personal purposes, it cannot be said that such property is used in a trade or business or held for the production of income, and therefore no depreciation deduction would be allowable.

Even if we were to recognize that the housing cooperative has an economic interest in the building sufficient to sustain an economic loss through depreciation of the building the added deduction for depreciation would give the corporation a fixed loss every year. No assessments have ever been made of the members for the depreciation deduction. This fixed loss year after year is inconsistent with carrying on a trade or business.

In taking this position we are not suggesting that the corporation is not entitled to deduct or offset the expenses it incurs in managing, maintaining, and otherwise caring for the housing property against its income, that is, against the monthly assessments paid by the tenant-stockholders to cover current operating costs. It is well-settled that while an activity may be carried on without any expectation of profit, a deduction or offset of the actual expenses incurred in carrying on this activity up to the amount of the income generated by it may be allowed. See *International Trading Co. v. Commissioner*, 275 F.2d 578 (7th Cir. 1960); *Henry P. White*, 23 T.C. 90 (1954); *Nicath Realty Co., Inc.*, T.C. Memo 1966-246.

(2) Whether Section 216(c) Allows Depreciation—The question was raised at the reconciliation conference held on February 23, 1971 whether section 216(c) and Regs. 1.216-2(b)(i) recognize that a cooperative housing corporation may depreciate its building. Regs. 1.216-2 provides:

Treatment as property subject to depreciation.—(a) General rule. For taxable years beginning after December 31, 1961, stock in a cooperative housing corporation (as defined by section 216(b)(1) and paragraph (c) of section 1.216-1) owned by a tenant-stockholder (as defined by section 216(b)(2) and paragraph (d) of section 1.216-1) who uses the proprietary lease or right of tenancy, which was conferred on him solely by reason of his ownership of such stock, in a trade or business or for the production of income shall be treated as property subject to the allowance for depreciation under section 167(a) in the manner and to the extent prescribed in this section.

(b) Determination of allowance for depreciation—(1) In general . . . the allowance for depreciation for the taxable year with respect to stock of a tenant-stockholder, subject to the extent provided in this section to an allowance for depreciation, shall be determined—

(i) By computing the amount of depreciation . . . which would be allowable under one of the methods of depreciation prescribed in section 167(b) and the regulations thereunder . . . in respect of the depreciable . . . real property owned by the cooperative housing corporation in which such tenant-stockholder has a proprietary lease or right of tenancy,

(ii) By reducing the amount of depreciation . . . so computed in the same ratio as the rentable space in such property which is not subject to a proprietary lease or right of tenancy by reason of stock ownership but which is held for rental purposes bears to the total rentable space in such property, and

(iii) By computing such tenant-stockholder's proportionate share of such annual depreciation . . . so reduced.

It is argued that both the Code and regulations recognize that the cooperative housing corporation is the owner of "property subject to the allowance for depreciation under section 167(a)" and therefore should be permitted a depreciation deduction with respect to that property. We do not believe that such a conclusion follows from a reading of the Code and regulations. Section 28 of the Revenue Act of 1962 amended section 216 by adding a provision (subsection (c)) permitting a tenant-stockholder of a cooperative housing corporation to treat some portion of his shares in the cooperative as depreciable property to the extent the tenant-stockholder's right of occupancy was used in his trade or business or for the production of income. As explained by Senator Sparkman in the Congressional debate:

If a person rents out that kind of property, he can deduct depreciation and expenses, and so forth; but the person who owns almost the identical same thing in a cooperative housing cannot do that. This amendment puts those persons on a par with the others. [Vol. 108 Cong. Rec. 18383]

Section 216(c) does not authorize or allow a depreciation deduction. It merely provides that for purposes of section 167, a portion of the stock of the tenant-stockholder will be treated as property subject to the allowance for depreciation under section 167(a). That is, the allowable deduction, though calculated pursuant to the provisions of Regs. 1.216-2, is not allowed by section 216 (as is the case with interest and taxes (see section 216(a)), but is permitted only by the provisions of section 167. It is, therefore, incorrect to refer to section 216 as a basis for the allowance of a depreciation deduction to the cooperative housing corporation.

It is also argued that the reference to depreciable property of the cooperative housing corporation and the depreciation in respect thereof has meaning only with regard to the determination of what amount of "depreciation" will be allowed to the tenant-stockholder because of section 216(c). This argument is based on the language of Regs. 1.216-2(b)(i) which provides for the computation of the amount of depreciation which would be allowable in respect of the cooperative's depreciable real property. This provision does not say that the cooperative is allowed depreciation. It merely says that if the tenant-stockholder would qualify for the depreciation deduction under the general rule stated in regulations section 1.216-2(a), the determination of such deduction will be made by taking into account the amount of depreciation which would be allowable to the cooperative assuming that the cooperative itself were entitled to the depreciation deduction on its property. Whether or not the cooperative is in fact entitled to a depreciation deduction is a question which cannot be resolved under section 216(c) but must be decided in accordance with the provisions of section 167.

(3) Application of Section 216(b)(1)(c)—In our reexamination of section 216(c) we also considered how the allowance of depreciation might affect other provisions of section 216. One of the provisions that we think will be affected is section 216(b)(1)(c). Section 216(b)(1) defines the term "cooperative housing corporation," to mean a corporation:

(c) no stockholder of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation. . . .

This provision was in the precursor of section 216 when it was enacted in 1942 and has remained in the same position, unexplained, since that time. The Senate Finance Committee Report merely states that

. . . the definitions of the term "cooperative apartment corporation" and "tenant-stockholders" prescribe certain standards which are designed to safeguard the revenue by assuring that the apartment corporations involved are bona fide cooperative apartment corporations and that the individuals entitled to deductions under section 23(a) [of the 1939 Code] are bona fide tenant-stockholders of such corporation. [S. Rept. 1631, 77th Cong. p. 97 (1942)]

The prevailing practice among housing cooperatives is to assess the tenant-shareholders only an amount sufficient to cover the current operating expenses. The assessment does not include an amount to cover the depreciation of the building. This is why the depreciation is an issue. By taking a depreciation deduction without an assessment to cover the depreciation cost the cooperative is able to generate a substantial loss every year. It is our opinion that the generation of this loss, precluding the cooperative from having earnings and profits, results in the cooperative making a distribution of capital to its tenant-stockholders in violation of section 216(b)(1)(c) with the resultant loss of its status as a "cooperative housing corporation."

If a cooperative housing corporation has a depreciable interest in the building entitling it to the depreciation deduction, then depreciation of the building should properly be treated as an expense of operation. If the cooperative housing corporation is to meet its requirement to serve its tenant-stockholders at cost the depreciation expense should be reflected in the assessments of the tenant-stockholders. If this expense is not assessed the tenant-stockholders are receiving living accommodations from the cooperative housing corporation at less than cost. When stockholders of a corporation receive goods or services from the corporation at less than cost or fair market value they should properly be deemed to have received a "constructive distribution." Cf. *International Trading Co.*, 17 TCM 521 (1958). Since the cooperative housing corporation has no earnings and profits the value of the "constructive distribution" represents a return of capital. This return of capital is a distribution to the tenant-stockholders that is not out of earnings and profits in violation of section 216(b)(1)(c). This should, therefore, result in the cooperative losing its status as a "cooperative housing corporation," and thus deprive its tenant-stockholders of their right to deduct their pro rata share of the real estate taxes and interest payments.

This result does not occur if the Service takes the position that a cooperative housing corporation does not have a depreciable interest in the building, is adopted. If the cooperative does not have a depreciable interest in the building then depreciation is not a proper expense of operation and the tenant-stockholders would not be required to pay an amount to cover the depreciation in order to retain the interest and real estate tax pass through benefits.

Attached is Appendix A which shows from an accounting standpoint how a cooperative that does not assess for depreciation would be deemed to have distributed its capital to its tenant-stockholders.

K. MARTIN WORTHY

Chief Counsel
Internal Revenue Service

* * *

Notes:

[a] This section explains why the depreciation deduction is not available to *condominium associations*. The balance of GCM 34613 explicitly states that a *cooperative housing corporation* is not entitled to a depreciation deduction for its building because it lacks sufficient economic interest in the building and it does not hold the building for trade or business purposes or for the production of income. General Counsel Memoranda are low on the hierarchy of precedential authorities, as illustrated in Appendix 1A. GCM 34613 was issued in 1971. Rev. Rul. 90-36 (Appendix 6H), which was issued in January 1990, clearly states and illustrates through example that a cooperative housing corporation is entitled to a depreciation deduction. Revenue Rulings may be cited as precedent. The change in the treatment of depreciation deductions for cooperative housing corporations was made as a result of the 1976 Tax Reform Act, which amended IRC Sec. 216 by adding the following sentence as IRC Sec. 216(c)(1):

> The preceding sentence shall not be construed to limit or deny a deduction for depreciation under 167(a) by a cooperative housing corporation with respect to property owned by such a corporation and leased to tenant-stockholders.

The IRS agreed in Ltr. Rul. 7924005 (Appendix 7B) that, as a result of the 1976 TRA amendment to IRC Sec. 216, a cooperative housing corporation is entitled to a deduction for depreciation on buildings leased to tenant-stockholders. The IRS contends, however, that, in the absence of the amendment to IRC Sec. 216 referenced above, a cooperative housing corporation would not be eligible to take a deduction for depreciation on those units. The amendment was effective for tax years beginning after December 31, 1973.

[b] The authors believe that the wording *next year's assessments* clearly indicates the intent of Rev. Rul. 70-604 (Appendix 6H) is to be a *one year carryover only*.

[c] As indicated in Note a, the authors believe that the wording *following year's assessments* clearly indicates the intent of Rev. Rul. 70-604 is to be a *one year carryover only*.

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