SOME LEGAL ASPECTS OF COOPERATIVE HOUSING

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Many veterans are today manifesting an interest in the formation of organizations through which they may obtain housing by group action. While all such organizations are popularly referred to as "housing cooperatives," many actually envisage the use of cooperative principles only in the acquisition of property. That is, they do not plan to manage and operate a housing development on a cooperative basis, but only to band together in constructing or purchasing homes after which the cooperative arrangement is at an end, each member becoming the title owner of the property occupied by him.

Others, however, wish to make further use of cooperative principles in the maintenance and operation of the project, whether it be an apartment development or one of separate homes. It is in planning an organization for this type of activity that the legal adviser is confronted with many legal problems foreign to the day-to-day practice of law. These are the problems that this article will attempt to discuss.¹

Briefly, the purpose of this type of cooperative housing is to combine most of the advantages of home ownership with the economy and stability of large scale enterprise. In addition to attraction from the financial standpoint, it is claimed that in planning such projects more attention can be given to landscaping, recreational facilities and other factors related to the livability of the property than commercial necessity will allow in the case of property constructed for investment purposes.²

Membership in the cooperative housing organization is based upon the ownership of a specified number of its shares, if a trust or a stock corporation, or upon the payment of the required membership fee in the case of a non-stock corporation. The total amount to be paid by all members for their required holdings is that which is necessary to take care of the preliminary expenses, pay for the organization's equity in the property, and provide such working capital as is considered desirable. This

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¹ The economic principles of cooperative housing are considered here only where necessary to the discussion of legal problems. Those interested in a general treatment of this subject should obtain U. S. DEP'T OF LABOR, ORGANIZATION AND MANAGEMENT OF COOPERATIVE AND MUTUAL HOUSING ASSOCIATIONS (Bur. of Labor Statistics, BULL. No. 858, 1946) which is for sale by the Superintendent of Documents, Washington 25, D. C., at twenty cents per copy. Request might also be made of the Economics and Housing Finance Branch of the National Housing Agency for the "Guide to Organizing Mutual Housing Associations Under the Veterans' Emergency Housing Program" which it expects to publish within a short time. For legal problems relating to cooperatives generally, see PACKEL, THE LAW OF COOPERATIVES (1940).

² MERLE HENRICKSON, WHAT ABOUT HOUSING COOPERATIVES (booklet published by Co-op Builders, Detroit, 1945); BULL. No. 858 *supra* note 1, at 5.

total capital requirement is then apportioned among the dwelling units on the basis of the cost of construction of each, and the size, location, and other factors of desirability. Thus a definite capital contribution is assigned to each dwelling unit and each member buys the shares or pays the fee placed upon the unit he selects for occupancy. The right to the occupancy of the designated unit is thus an incidence of membership, but it also requires compliance with the terms and conditions which are fully set out in the instruments governing the method of operation of the organization. Each member is given a long-term lease, renewable at his option, which also specifies the terms and conditions of occupancy including the requirement of payment in advance of the monthly charges and adherence to the by-laws and rules of the organization.

The monthly charges are fixed by the managing body to provide the amounts necessary to meet current operating expenses, make the required payments on the debts of the organization, and contribute toward building up proper reserves. Any doubt as to the sufficiency of the charges is resolved in favor of an increase because the amount by which a charge proves excessive is refunded to the members annually or at other regular intervals. As will be later discussed, the amount of these rebates is not necessarily income to the organization for Federal income tax purposes.

THE FORM OF ORGANIZATION

In considering the legal form the organization is to use, the necessity of an entity which will provide limited liability is obvious. This precludes the use of a partnership (even a limited partnership requires at least one general partner), joint venture, unincorporated association,³ or ownership and management of the property by the members as tenants in common.⁴ It leaves for consideration a trust organization and several kinds of corporations.

The Trust Form

The trust form of organization for cooperative housing is discussed in an article on "Legal Phases of Cooperative Building,"⁵ which describes an arrangement where the property is conveyed to a trustee who issues a declaration of trust. This states that the purpose of the trust is to allocate to the beneficiaries the exclusive right of occupancy of apartments according to the certificate of beneficial interest held by each, together with the use of public rooms and facilities during the life and subject to the provisions of the trust. The declaration then provides for mutual contributions (presumably monthly) to meet expenses, and sets out the obligations of each beneficiary, of which the following are examples: (1) to pay his proportionate share of the expense of operation; (2) to observe the rules which may be imposed from time to time regarding the use of the apartment and other facilities; (3) not

³ 4 AM. JUR., *Associations and Clubs*, §41.

⁴ While it does not necessarily follow that there will be unlimited liability because of a tenancy in common, the cooperative operation of a project would risk a holding that the enterprise constituted a partnership. 14 AM. JUR., *cotenancy*, §3.

⁵ Otis H. Castle in (1928) 2 SO. CALIF. L. REV. 1.

to use or permit the apartment to be used for any purpose prohibited by the declaration of trust or by law; (4) to surrender possession upon termination of his rights under the declaration; and, (5) not to transfer any portion of his beneficial interest except in accordance with rules which might from time to time be adopted. In the event of default in the performance of a member, the trustee may sell the certificate of the individual involved at public auction.

Provision is made for the election by the beneficial owners of a board of governors to act in an advisory capacity to the trustee in supervising the operation of the project; but the ultimate power of control in all matters is vested in the trustee. The beneficiaries are bound by an agreement with each other and with the trustee not to partition, divide, or otherwise set apart any interest, legal or equitable, under the trust. However, upon the vote of a specified percentage of beneficiaries, the trustee must sell the property and divide the proceeds among the beneficiaries or convey the property to a corporation in which the beneficiaries are the shareholders. These obligations are summarized on certificates entitled "Assignment of Beneficial Ownership and Interest" which convey a specified fractional interest in the trust together with the right of permanent occupancy to a named apartment in accordance with the terms of the trust.

The trust arrangement does, of course, have flexibility and may be drafted to vary considerably from the type just summarized. It is thought, however, that any suitable plan which adequately protects the interests of all concerned will of necessity be quite complex. When it is considered that the law relating to trusts is neither as definite nor as well understood by lawyers as corporation law, it is seen that the task of safeguarding against legal pitfalls is rendered extremely difficult.

Moreover, the use of the trust form for a cooperative housing organization results in either the abandonment of democratic control by the members or a risk of personal liability on their part. This undesirable choice stems from the fact that even in states which recognize Massachusetts trusts, the right of members to manage the affairs results in their being held personally liable as partners upon the obligations of the enterprise.⁶

While the risk of personal liability is undesirable, the alternative to it under the trust form, the relinquishment of democratic control, is equally unsatisfactory. It would remove mutuality of responsibility in the management of the project and almost certainly invite an apathy which would be destructive of community spirit and morale. The right of the members to manage is such an important element in cooperation that it has been held to be a fundamental characteristic, the absence of which prevents an organization from obtaining statutory benefits granted to a cooperative.⁷

As Mr. Justice Brandeis described the purpose of farmers' cooperatives:

⁶ 16 FLETCHER, PRIVATE CORPORATIONS (1942 Replacement) §8230; 2 SCOTT, TRUSTS (1939) §274.1.

⁷ *Keystone Automobile Club Casualty Co. v. Comm'r*, 122 F. (2d) 886 (C. C. A. 3rd, 1941). *Cert. den.*, 315 U. S. 814 (1942).

"Besides promoting the financial advantage of the participating farmers, they seek through cooperation to socialize their interests—to require an equitable assumption of responsibility while assuring an equitable distribution of benefits. Their aim is economic democracy on lines of liberty, equality and fraternity."⁸

If, notwithstanding these disadvantages, the trust form is to be used, rules applicable to the internal organization of corporations may suggest a general outline for the trust plan.

The Corporate Form

The latitude which the corporate form will offer in formulating the organization depends largely upon the nature of the project and the incorporation provisions of the state. All states authorize the incorporation of business and non-profit corporations, but in addition, in some states it is possible to incorporate under laws expressly applicable to limited dividend housing corporations or cooperatives.

Limited Dividend Housing Corporations

The special incorporation of private limited dividend housing corporations has been authorized in at least 13 states as a means of making housing available to lower income groups and aiding in the elimination of slums and blighted areas.⁹ In addition, Wisconsin has a statute¹⁰ authorizing the incorporation of housing corporations similar to limited dividend corporations, but with some cooperative characteristics.

As the name indicates, these statutes place limitations upon profits and usually the states exercise regulatory functions through housing boards with respect to the operations of the corporations. In Delaware, New Jersey and New York special provisions open the way for the exemption of the property of these corporations from taxation.

With the exception of the Wisconsin statute, these laws are designed not so much for mutual or cooperative organizations, but rather to attract the capital of private investors to the low-cost rental housing field. There is nothing, however, to prevent a cooperative group from incorporating under them and receiving the tax exemption or other benefits offered. In that event, the necessity of complying with special regulations or furnishing reports to the state housing body, should not unduly restrict the organization's activities if it is interested in cooperative housing as opposed to speculative profits.¹¹

⁸ Dissenting opinion in *Frost v. Corporation Commission*, 278 U. S. 515, 536; 49 S. Ct. 235, 243, 73 L. Ed. 483, 495 (1929).

⁹ ARK. STAT. (1937) §12256; CAL. GEN. LAWS (Deering, 1937) Act 3481, §1 *et seq.*; DEL. REV. CODE (1935) §5439; FLA. STAT. ANN. (1943) §424.10; ILL. STAT. ANN. (Jones, 1939) §63.20 *et seq.*; KAN. GEN. STAT. (1935) §17-2314; MASS. ANN. LAWS (1942) C. 121, §26E; N. J. STAT. ANN. (perm. ed.) §55:15-6; N. Y. PUB. HOUSING LAW §170 *et seq.*; OHIO GEN. CODE ANN. (Page, 1937) §1078-15; PENN. STAT. ANN. (Purdon, perm. ed.) §1601 *et seq.*; S. C. CODE (1942) §5271-18; TEX. CIVIL STAT. (Vernon, 1945 replacement) Art. 1524b.

¹⁰ WIS. STAT. (1945) §180.04.

¹¹ The benefits and burdens of the law must be weighed in each particular case; e.g., the New York law, while opening the way for tax exemption, requires that any surplus remaining upon dissolution after payment of the par value of the stock plus accrued, unpaid dividends and interest, shall go to the state or municipal treasury. N. Y. PUB. HOUSING LAW §185.

The Wisconsin law¹² was enacted in 1919 in an effort to alleviate the shortage which existed at that time in housing for lower income workers. It allows the incorporation of housing companies to have in general the power of other corporations. Two classes of stock, common and preferred as to dividends only, are authorized, and the holders of either are entitled to one vote for each share. The common stock is to be held only by those renting housing from the corporation, while the preferred stock may be purchased by anyone, including a city or county government. Dividends may be declared only after a surplus fund equal to 2 per cent of the paid in capital has been accumulated, after which they may be declared on both classes of stock, but the dividends on the preferred stock may not exceed 5 per cent per year. The interest of a tenant in his lease and stock is declared to be exempt from execution to the same extent as a homestead in real estate.

A corporation organized under this law may cancel a member's lease only for a violation of the terms thereof, but a member may terminate it at any time by giving notice as the corporation shall require, up to 90 days. The corporation must then cancel the member's stock and return to him the amount he has paid on it or give him a note for that amount payable in one year at 5 per cent interest. Thus common stockholders can transfer their stock only to the corporation which may not resell it at less than par. Originally, there was no authority to convey the title to a home to an individual stockholder, but this was authorized in 1925 by an amendment of the act.¹³ The corporation may decide to dissolve by a majority vote of all outstanding stock in which case the proceeds are divided among the stockholders.

The placing of a limitation upon dividends to be paid preferred stockholders is a feature of a limited dividend housing corporation, but joining the ownership of common stock with a right of occupancy of a dwelling unit presents an important features of a cooperative housing corporation. From this standpoint it is interesting to note that: (1) a shareholder may terminate his lease at any time and receive what he has paid on his stock; (2) the corporation may resell the stock at more than par value and thus realize a profit from new members; (3) the stockholders share in the profit upon dissolution; (4) the corporation may sell a shareholder the dwelling he occupies; and, (5) preferred stockholders (who are not tenants) have a voice in the management.¹⁴

These features might leave an organization open to the possibility that in times of low real estate prices so many members would withdraw that the corporation would be unable to find new members and would have insufficient liquid reserves to pay the withdrawing shareholders. On the other hand, in a high price period

¹² *Supra* note 10.

¹³ Wis. Laws 1925, c. 321, Wis. STAT. (1945) §180.04(13). An interesting description of the operation of a corporation organized under this law is found in *Garden Homes Co. v. Comm'r*, 64 F. (2d) 593 (C. C. A. 7th, 1933). Cf. *Amalgamated Housing Corp.*, 37 B. T. A. 817 (1938) *aff'd* without opinion 108 F. (2d) 1010 (C. C. A. 2d, 1940), which involved a corporation incorporated under the New York Law, *supra* note 9.

¹⁴ The requirement in the statute that a reserve be established for the retirement of preferred stock indicates that it is authorized only as an expedient in financing and that the intent is ultimately to have full stock ownership in the tenants.

members would be tempted to purchase their dwellings purely for speculative purposes. Since they could resell at a high price the purpose of the statute of making housing available at a reasonable price to those with low incomes would be defeated. Also, if the preferred stockholders who have voting rights were not public spirited, they might exert pressure to end the project during a high real estate market in order to realize the profit involved.

This does not, however, render the Wisconsin housing corporation law unsuitable for a cooperative organization. The articles and by-laws could easily be drafted with an eye toward obviating these possibilities of project suicide.

Incorporation Under Cooperative Laws

In many states the cooperative association laws are designed only for agricultural marketing or other specific cooperatives and will not permit the incorporation of a cooperative designed to furnish housing to its members. Where, however, those laws are broader, they ordinarily provide the best basis of organization for a cooperative housing association.

An example of the difference between a cooperative association statute and one for the incorporation of a business organization may be had by reference to the Cooperative Association Act of the District of Columbia.¹⁵ Under it, the cooperative is deemed a non-profit association. Each member has only one vote regardless of his holdings, and proxy voting is prohibited. The act provides that two-thirds of the members present at a meeting may remove a director or officer and to further insure democratic control, the articles or by-laws may provide for the holding of referendums upon acts of the directors. A member may be expelled by a majority vote in which event the board of directors must purchase his holdings at par value "if and when there are sufficient reserve funds." If a member wishes to withdraw, the association has a 60 day option to purchase his holdings at par. If that is not exercised, the member may sell them elsewhere *subject to the approval of the transferee* by a majority vote of the directors. If the directors fail to approve, appeal may be made to the members at the next meeting and their action shall be final, but if the vote is against approval of the transferee, the association must purchase the holdings "if and when such purchase can be made without jeopardizing the solvency of the association."

The act does not require an association to have an office or agent in the District of Columbia and it is not necessary that any individual connected with an association be a resident of that place. The association is specifically authorized to "conduct its affairs within or without the District of Columbia" and the fee for incorporation is only six dollars. These factors make the incorporation statute one which would be advantageous for use by an organization which intends to operate a cooperative project in any state, if the local laws relating to foreign corporations are not unduly onerous.

¹⁵ D. C. CODE (1940) tit. 29, §801 *et seq.*, 54 STAT. 480 (1940).

Non-profit Corporation Laws may ordinarily be used in incorporating the association since, as will be pointed out in the discussion on taxation of cooperatives, there is really no pecuniary profit.¹⁶ However, there are some exceptions to this general rule.¹⁷ *General Corporation Laws* also may be used in the absence of a statutory prohibition,¹⁸ but difficulty may be encountered when an attempt is made to provide for the policy to be followed in proxy voting, expelling undesirable members, restricting the transfer of stock, etc. While the corporation can often be given the power by the articles or by-laws to carry out the desired policy of these matters, limits may be prescribed by the statute of incorporation.

Size of the Share Subscription. It would seem to be in the members' interest to limit the capitalization of the corporation to the amounts necessary to defray organizational expenses, pay for the equity to be held, and provide working capital. In this way, the amount of shares issued to each member will be kept at a minimum. Also, there will be no unpaid subscriptions for the purchase of shares which would be a personal liability of the subscribers in the event of insolvency.

A mortgagee might require that there be some personal liability of the members for the debt where the mortgage covers a large percentage of the value of the property, but this is not likely if the mortgage is to be insured by the Federal Housing Administration or if a loan to the cooperative can be insured or guaranteed by the Veterans Administration. Such insurance and guarantees will be discussed *infra*.

Proxy Voting. In the ordinary corporation stockholders who reside some distance from the meeting place or whose holdings are small, might be virtually denied a voice in the corporate affairs except for the allowance of proxy voting. But a member of a housing cooperative does not require this method of voting. Presumably the meetings will be held at the development where he resides. His interest, financial and otherwise, will closely approximate those of any other member. Moreover, if there is to be effective democratic control and the keen interest in project affairs so essential to its success, the meetings must be as representative as possible of the entire membership. Since proxy voting might be a deterrent to personal attendance and might be used as a tool to enable a few persons to gain control, the more prudent course would be to prohibit it altogether if the incorporation law allows.¹⁹

Expulsion of Members. If the corporation is organized under a cooperative or non-profit corporation law, a statutory procedure may provide for the expulsion of undesirable members. If not, or if incorporation has taken place under the general corporation laws, a provision in the charter or articles, or a by-law in force at the

¹⁶ *In re Estate of Pitts*, 218 Cal. 184, 22 P. (2d) 694 (1933); *Read v. Tidewater Coal Exchange*, 13 Del. Ch. 195, 116 A. 898 (1922); 1 FLETCHER, PRIVATE CORPORATIONS (perm. ed., 1931) §§68, 112.

¹⁷ *State v. Home Cooperative Union*, 63 Ohio St. 547, 59 N. E. 220 (1900). The Pennsylvania non-profit corporation law "does not relate to, does not affect, and does not apply to cooperative associations, whether for profit or not for profit." PENN. STAT. ANN. (Purdon, perm. ed.) §2851-4.

¹⁸ The Pennsylvania business corporation law contains a provision similar to that quoted *supra* note 17 (§2852-4).

¹⁹ There is no right to proxy voting at common law, 5 FLETCHER, PRIVATE CORPORATIONS (perm. ed.) §2050, but statutes generally require the corporation to allow it; e.g., N. Y. STOCK CORP. LAW §471; N. J. STAT. ANN. (perm. ed.) §14:10-9.

time of creation (or assented to by *all* the members) will usually confer this right.²⁰ The entire procedure for enforcement must, of course, be drafted with care in order to protect the members, both as a group and as individuals. One possible method is to make a violation of a term of the lease the ground for expulsion with complaints to be investigated by a committee appointed by the board of directors. The investigation would include the right of the member to be heard and if the committee recommended expulsion a membership meeting would be called which, after the presentation of both sides of the controversy, could expel the member by a two-thirds vote of those in attendance. If the member is expelled, his lease would be cancelled and he would receive notice to move. His stock or certificate of membership would also be cancelled upon the payment by the corporation of its original cost plus the proportionate share of any increases in the corporation's equity or other additions to capital. As an alternative, the payment for the holdings might be expressed in terms of the current book value or some other method of valuation capable of ascertainment and not too susceptible of dispute. In addition, if a refund is later made for the period during which the individual was a member, he would be entitled to his proportionate share of that. The important thing is to provide a procedure which will be both swift and just so that if the occasion for its use should unfortunately arise, the possibility of a permanent scar will be minimized.

Democratic Control. While the authority of the directors to carry out policy and matters of management must not be impaired, the members of a housing cooperative, unless it is an unusually large one, are in a better position to determine specific policies than stockholders of the ordinary corporation. Accordingly, regular membership meetings should be more frequent than the annual stockholders' meetings common to business corporations. Procedure for a referendum upon the acts of the directors and a right of recall of directors and officers would also strengthen membership control. Proper safeguards may be desirable, however, to prevent such hasty group action that ill-considered decisions would result.

Transfer of Membership. Since the success of the project depends upon the quality of the members and the ability of each to live in harmony with the others, it seems essential that where a member wishes to withdraw the organization have some voice in the approval of his successor. The organization must, however, act fairly since the ability of the withdrawing member to liquidate his holdings must be protected.

In addition to control with regard to the identity of the transferee, a decision must be made as to whether control will be exercised over the selling price of the holdings. This is a highly controversial matter of policy which should be settled at the outset. On the one hand, some may feel that if they risk their money in the success of the organization and later wish to withdraw, they should be entitled to all that the market will pay for their holdings. Others, however, will argue that in a cooperative project there is no place for the speculative factor. The purpose of mem-

²⁰ 12 FLETCHER, PRIVATE CORPORATIONS (perm. ed.) §5696.

bership is to provide economical housing and future members must be protected from paying a price which would give a retiring member a speculative profit; otherwise, the new members will not really be getting cooperative housing. Also, a high market might see a succession of members more interested in profits than in cooperating toward providing comfortable, economical housing for all.²¹ Subleasing could also result in occupancy by non-members who would be forced to pay high rents to absentee members engaged in making a profit from the enterprise. Obviously this, too, is foreign to the purpose of a cooperative project. Accordingly, it is common to allow subleasing only where a member is to be temporarily away and even then regulate the amount he may charge.²²

To prevent this type of degeneration, the by-laws and leases may provide that membership, share certificates, or leases, may not be assigned nor the premises sublet without the approval of the board of directors, or if the board refuses, without approval by a vote of the membership. These restrictions would also be printed on the certificates of stock or membership so there could be no claim or lack of notice. Notwithstanding the general rule which ordinarily prevents a restriction on the transferability of stock, those of this type have been held valid as necessary to protect the purposes of the corporation.²³ Control over the price to be paid by subsequent transferees may also be obtained by a by-law which would require a member to offer his holdings to the corporation at a specified method of valuation before selling elsewhere.²⁴ Exemptions from these requirements could be made for transfers to a spouse, child or parent, and for disposition in accordance with the terms of a will or the law of intestate succession.

Provision concerning these matters should be drafted with an eye to the fact that the subscription agreements, by-laws, leases, and other organizational plans must be construed together as a contractual arrangement.²⁵ Thus, where these instruments contain a procedure for terminating leases and do not reserve the right to alter that procedure, any change would be in effect a modification of the contractual arrangement made by all the members with themselves and with the corporation. The adoption of a new by-law providing a new procedure would therefore require the unanimous assent of the stockholders.²⁶

Dividends. As will be discussed later, receipts of a housing corporation which are later distributed to the members as dividends on the stock, are considered income subject to the Federal income tax, but receipts distributed as patronage refunds are

²¹ It is evident, however, that if the property is acquired during a period of high costs, a member who started with a sizable equity does risk, if he later wishes to withdraw, having to sell his holdings at a loss, or even being unable to sell them at all, because of a low market.

²² WOOD, RECENT TRENDS IN AMERICAN HOUSING (1931) 172; 4 ENCYCLOPEDIA OF THE SOCIAL SCIENCES (1935) 517; BULL. No. 858, *supra* note 1, at 33.

²³ 68 Beacon St. v. Sohler, 289 Mass. 354, 194 N. E. 303 (1935); Penthouse Properties v. 1158 Fifth Avenue, 256 App. Div. 685, 11 N. Y. S. (2d) 417 (1939).

²⁴ 12 FLETCHER, PRIVATE CORPORATIONS (perm. ed.) §55456, 5457.

²⁵ Tompkins v. Hale, 172 Misc. 1071, 15 N. Y. S. (2d) 854 (1939), *aff'd*, 284 N. Y. 675, 30 N. E. (2d) 721 (1940).

²⁶ *Ibid.*

not taxable. Since stock ownership will in general be proportionate to monthly charges, a member will receive about the same amount irrespective of whether the dividend or refund method of distribution is used. Also, by adopting a by-law which clearly removes any possibility of profit-making by the corporation, or the payment of dividends by it, its claim to a non-profit status (even though it is organized under a general incorporation law) would obviously be strengthened.

Lien on Stock. If the by-laws provide that the corporation will have a lien upon the members' stock or other holdings for the monthly charges, a statement to that effect should appear on the certificate of stock.²⁷

FEDERAL INCOME TAXATION

If an individual homeowner allots \$50 from his pay each month for repayment of the mortgage on his home any increase in his equity at the end of the year represents a savings from the monthly payments rather than new income to him. Similarly, when a housing cooperative is viewed simply as a group of individuals, each of whom is purchasing what amounts to ownership of a home—the right to live in a particular dwelling—it is apparent that there should be no income tax liability for the amount by which its receipts exceed expenses.

The applicability of this analogy, however, depends upon the disposition the cooperative corporation makes of its receipts. If they are refunded to members on the basis of patronage, they are not income for they are not a division of profits but instead a return of the overcharge.²⁸ On the other hand, if receipts are distributed on the basis of the ownership of stock, that is, as earnings on the capital investment of the stockholders, they are taxable as income to the corporation.²⁹

In the case of a housing cooperative, as has already been pointed out, the ownership of stock ordinarily is in proportion to the desirability of the unit occupied and hence to the monthly charge. Thus, whether the distribution is in the form of a dividend on stock ownership or a refund of monthly charges, a member is apt to receive about the same amount. With respect then, to the charges to be distributed to members, it would seem easy to bind the corporation to return them in the form of patronage refunds and incur no liability for income tax.

However, all collections from members which are not used for expenses cannot be refunded because payments must be made on the principal of the mortgage and reserve funds should be built up to meet various contingencies. Since this constitutes an increase in the net worth of the cooperative the question arises whether it evidences the receipt of taxable income.

²⁷ 8 FLETCHER, PRIVATE CORPORATIONS (perm. ed.) §4207 and *id.* Vol. 11, §§5264, 5265.

²⁸ *Uniform Printing and Supply Co. v. Comm'r*, 88 F. (2d) 75 (C. C. A. 7th, 1937); *Packel, Cooperatives and the Income Tax* (1941) 90 UNIV. OF PA. L. REV. 137, 151; G. C. M. 17895, C. B. 1937-1, 56. But the following recent cases have further required that at the time the money was received, the articles, by-laws, or a contract imposed a liability on the association to return excessive charges in the form of patronage refunds: *American Box Shook Export Ass'n v. Comm'r*, 156 F. (2d) 629 (C. C. A. 9th, 1946); *United Cooperatives, Inc. v. T. C.* 93 (1944).

²⁹ *Farmers Union Co-op Co. v. Comm'r*, 90 F. (2d) 488 (C. C. A. 8th, 1937).

If it can be said that the increase represents profits made by the corporation in dealing with those to whom it has rented housing, there is taxable income.³⁰ On the other hand, the tenants are also the stockholders (or, in a non-stock corporation, the holders of certificates) and if the increase in net worth came as the result of capital contributions from them, it is not taxable as income.³¹

Thus, a provision in the by-laws or leases that any charges not used for expenses or refunded to the members will be credited upon the books of the cooperative as contributions to capital accounts will save the corporation from Federal income tax liability.³² This is not a tax-dodge but only a fair result, for, as has already been pointed out, the increase in capital which results from the members' payments is no more new income than is the enlargement of a homeowner's equity.

But when the homeowner computes his taxable income, he may also deduct the interest charges on his mortgage³³ and the real estate taxes on his home.³⁴ The opportunity for a similar deduction is given the individual members of a housing cooperative by Section 23(z) of the Internal Revenue Code.³⁵ That section allows a "tenant-stockholder"³⁶ of a "cooperative apartment corporation"³⁷ to deduct his proportionate share of taxes and interest paid or incurred by the cooperative in computing his individual income tax liability.

³⁰ *Amalgamated Housing Corp.*, *supra* note 13. Cf. *San Joaquin Valley Poultry Producers' Ass'n v. Comm'r*, 136 F. (2d) 382 (C. C. A. 9th, 1943), with *Cooperative Oil Ass'n, Inc. v. Comm'r*, 115 F. (2d) 666 (C. C. A. 9th, 1940).

³¹ 874 Park Ave. Corp., 23 B. T. A. 400 (1931); and I. T. 1469, C. B. I-2, P. 191 in which the Commissioner of Internal Revenue ruled:

"Considering the specific provision of the proprietary lease for crediting payments made by the stockholders for the reduction of the mortgage indebtedness or for other capital expenditures to the 'paid-in surplus' account in connection with the fact that the books of the corporation reflect the amount of the assessment payments used for such purposes and that the stockholders are advised of the respective amounts so applied, it is held that the portion of the assessment payments credited to the 'paid-in surplus' account . . . is in the nature of a voluntary assessment upon the stock held by the individual proprietary lessees, which, under Article 544, Regulation 62, represents additional cost of such stock, and does not constitute income to the corporation."

³² *Ibid.* For the right of a cooperative organized to furnish low-income families housing to an exemption from Federal income taxes as a non-profit civic organization under what is now Section 101(8) of the Internal Revenue Code [26 U. S. C. A. §101(8)] see the two cases cited *supra* note 13. (The organizations there involved did not treat their reserves as capital contributions; hence the claim of tax liability.)

³³ Sec. 23(b) of the Internal Revenue Code. 26 U. S. C. A. §23(b).

³⁴ *Id.*, §23(c); 26 U. S. C. A. §23(c).

³⁵ 26 U. S. C. A. §23(z).

³⁶ The section defines "Tenant-stockholder" as:

"An individual who is a stockholder in a cooperative apartment corporation, and whose stock is fully paid-up in an amount not less than an amount shown to the satisfaction of the Commissioner as bearing a reasonable relationship to the portion of the value of the corporation's equity in the building and the land on which it is situated which is attributable to the apartment which such individual is entitled to occupy."

³⁷ The section defines "cooperative apartment corporation" as one:

"(i) having one and only one class of stock outstanding,

"(ii) all of the stockholders of which are entitled, solely by reason of their ownership of stock in the corporation to occupy for dwelling purposes apartments in a building owned or leased by such corporation, and who are not entitled, either conditionally or unconditionally, except upon a complete or partial liquidation of the corporation, to receive any distribution not out of earnings and profits of the corporation, and

"(iii) 80 per centum or more of the gross income of which for the taxable year in which the taxes and interest described in paragraph (1) are paid or incurred is derived from tenant-stockholders."

The reference in that section to "cooperative apartment corporations" raises some question as to whether the member of a cooperative which owns single family dwellings would be entitled to the deductions. No interpretation has been found, but it is thought the word "apartment" in the statutes should include all units of a cooperative regardless of whether they are all in an "apartment" building.

FINANCING

In obtaining that part of the project's cost which is not to be paid for from capital contributions, any of the many forms of corporate finance may be used, but first mortgage financing offers the least complex method and one which the entire membership is most likely to understand. This may take the form of a construction loan with refinancing upon completion, or construction advances under an arrangement whereby the advances become the loan in definitive form.

It would be advantageous if the mortgage permits voluntary prepayments of the mortgage principal with a consequent reduction in interest, and provides that the debt will not be in default because of the non-payment of principal so long as the total amount credited to the repayment of principal equals or exceeds what would have been credited had only the regular monthly payments been made. In this way the reserves of the cooperative may be applied to the debt as advance payments. The interest saved will exceed what could be realized from any safe, liquid investment, and whenever the cooperative wishes to draw upon the reserves (for example, to make repairs or purchase the holdings of a retiring member) it need only withhold the necessary amount from the next monthly payment to the mortgagee.

Section 608 of the National Housing Act, as amended,⁸⁸ allows the Federal Housing Commissioner to insure mortgages on a housing project built by a corporation for an amount up to 90 per cent of the necessary current cost of construction of the property. If the mortgage exceeds \$200,000 the Federal Housing Commissioner requires that he be assigned shares of special stock "or other evidence of beneficial interest in the mortgagor" by which he will acquire majority voting rights during the period of any default on the mortgage or a violation of any agreement relating to it.⁸⁹ If special stock is issued for this purpose, the cooperative would apparently fail to meet the requirements of Section 23(z) of the Internal Revenue Code, *supra*, because there would be more than one class of stock, and thus the members could not deduct their proportionate share of interest and taxes in computing their individual Federal income tax liability. A cooperative, however, in this situation might be able to arrange with the Federal Housing Administration to come within the terms of Section 23(z) by a contractual arrangement or a by-law which would give the Commissioner control of the organization during a period of default or violation.

⁸⁸ 12 U. S. C. A. §1743.

⁸⁹ FED. HOUSING ADM., ADMINISTRATIVE RULES AND REGULATIONS FOR RENTAL HOUSING INSURANCE UNDER SECTION 608 OF THE NATIONAL HOUSING ACT (pamphlet, August 15, 1946) 16. This pamphlet may be obtained from any office of the Federal Housing Administration and should be consulted for the specific conditions under which loans are insurable. The "Guide," *supra* note 1, is expected to contain a thorough discussion of the various types of financing adaptable to the use of a housing cooperative composed of veterans.

Since a cooperative organization formed today is likely to be composed of veterans of World War II, the question arises as to loan benefits under the Servicemen's Readjustment Act of 1944, as amended⁴⁰ (hereafter referred to as the GI Bill). Under Section 501 of that Act as amended, 50 per cent of a loan to a veteran for purchasing or constructing residential property will be guaranteed by the United States but the total amount guaranteed may not exceed \$4,000. Under Section 505, where a veteran's home loan is approved for insurance by the Federal Housing Administration, the Veterans Administrator may guarantee the full amount of a second loan if it does not exceed 20 per cent of the purchase price or cost of the property. This enables the veteran to obtain 100 per cent financing.

A third type of loan under the GI Bill is provided for in Section 508 which specifies that in lieu of a guaranteed loan, certain financial institutions may agree for insurance of an amount equal to 15 per cent of the aggregate loans made or purchased. Under this arrangement the Veterans Administration will pay the full amount of losses of the approved financial institution except that the total amount it pays may not exceed 15 per cent of all such loans made or purchased by the institution.

Where any loan is guaranteed, the Veterans Administration pays an amount equal to 4 per cent of the amount originally guaranteed, such payment to be applied on the loan.⁴¹ If the loan is insured, the veteran gets the benefit of a similar payment.⁴²

But the present interpretation of the Veterans Administration seems to be that these provisions are in general applicable only to loans directly to the individual veteran and that in the case of a loan for a home, the veteran himself should hold title. Thus the current regulations of the Veterans Administration provide that there will be no automatic guarantee or insurance of a loan which is made

"... for the purchase of a home or as part of a housing development, cooperative or otherwise, existing or to be constructed: (a) the legal title to which home is not to be held directly by the veteran in the form of a separate estate in real property; or, (b) which is a departure from the conventional type of single family form of housing, nor to any loan for business or farming purposes which is in excess of \$25,000, or is related to an enterprise in which more than ten veterans will participate.

"No such loan or loans will be eligible for guaranty or insurance without the prior approval of the Administrator, who may issue such approval upon such terms and conditions, not inconsistent with the act, as he may deem proper."⁴³

Under this regulation, loans to a housing cooperative cannot be guaranteed or insured under the G. I. Bill unless there has been prior approval by the Veterans Administrator. This requirement that cooperatives be considered on an individual

⁴⁰ 38 U. S. C. A. §694.

⁴¹ Sec. 500(c) of the Act, 38 U. S. C. A. §694.

⁴² Sec. 508(c) of the Act, 38 U. S. C. A. §694i(c).

⁴³ §36.4343, Veterans Administrator's Regulations Under Servicemen's Readjustment Act of 1944, 11 FED. REG. 9701 (1946) §36.4350 of these regulations (11 FED. REG. 2125 (1946) provides that a merchantable title includes a leasehold estate for not less than 14 years from the maturity of the loan.

basis is no doubt an indication that the Veterans Administration has not yet formulated a definite policy regarding them and thus wishes to have the benefit of examining proposed methods of operations. It is hoped that as the result of the experience thus gained the Veterans Administration will announce the type of cooperative organization which can obtain a loan eligible for guarantee or insurance under the G. I. Bill. Even should the very strict view prevail that the G. I. Bill does not extend to a loan directly to a cooperative, it would still seem to permit the use of a cooperative plan whereby loans would be eligible when made to each individual member on the security of an estate in the property to be occupied by him. The disadvantage of this later method is the complexity incident to granting title or a long term lease to each unit to the member who is to occupy it. Also, the necessity of a long term loan on which an individual would be personally liable even though he left the project would deter many from becoming members.

INDIVIDUAL VS. CORPORATE TITLE

In forming the cooperative, especially if the project is to consist of single family dwellings, the question is almost certain to arise: "Why can't title to my house be in my name with the cooperative performing services incidental to its operation and maintenance?" This, indeed, is a question with many angles. Title ownership offers more than a mere feeling of security: ordinarily where the property owned is a homestead, it has a statutory exemption from execution for the debts of the owner. This policy which has for its purpose the encouragement and promotion of the stability of home ownership, has been implemented in some jurisdictions by allowing tax exemptions for homesteads.⁴⁴ Also, some states allow a special tax exemption for property owned by veterans.⁴⁵ While no case directly in point has been found, it is thought that a member of a housing cooperative would be unable to avail himself of these privileges except to the extent that the state law may make them applicable to a lease on a home.⁴⁶

Another argument in favor of having title in the individuals is that so long as a member meets the mortgage payments on his home he cannot lose it, whereas if title is in a cooperative which becomes insolvent, those members who are not in default also lose their holdings. It may be said in refutation, however, that in unity there can be strength and by building reserves, the cooperative can carry members

⁴⁴ E.g., ALA. CODE (1940) tit. 51 §15; ARK. STAT. (1944 Supp.) §13702a *et seq.*; FLA. CONST. ART. 10, §7 and FLA. STAT. ANN. (perm. ed.) §167.72; LA. CONST. 1921, Art. 11, §§1, 4 and LA. GEN. STAT. (Dart, 1939) §3805; MINN. STAT. (Mason, 1940 Supp.) §1993; MISS. CODE (1942) §9714; OKLA. CONST. ART. 10, §22 and OKLA. STAT. ANN. (perm. ed.) tit. 68, §34; TEX. CONST. Art. 8, §1-2; WYO. LAWS 1945, c. 42.

⁴⁵ E.g., N. M. STAT. (1941) §76-111, 113; N. Y. TAX LAW §4(5) (Property purchased with the proceeds of a pension, bonus, or insurance exempt from taxation); UTAH CODE (1943) §80-2-4 (property of disabled veterans); WYO. LAWS 1945, c. 140.

⁴⁶ See the following cases which considered the members not as owners, but as lessees having rights against and obligations toward the corporation which is the owner. *Prudence Co. v. 160 W. 73rd St. Corp.*, 260 N. Y. 205, 183 N. E. 365, 86 A. L. R. 361 (1932); *Shaffer v. 8100 Jefferson Ave. East Corp.*, 267 Mich. 437, 255 N. W. 324 (1934); *In re 325 East 72nd St., Inc.*, 173 Misc. 347, 18 N. Y. S. (2d) 159 (1940).

who must temporarily be in default. An actual example is that of the Amalgamated Housing project which, although it was built during the high cost era of 1926, was able to carry \$160,000 in back payments for families during 1932 and 1933.⁴⁷ It can be noted, too, that if a member makes only a small equity payment, he actually has little to lose because his monthly payments should not be in excess of, and will probably be less than the rental value of the unit he occupies.

No attempt will be made here to set out the variety of plans which can be devised to join individual ownership with cooperative management and operation. The only limits are the ingenuity of the legal advisor who can judge at first hand the desires and needs of the particular group with which he is working. The two basic plans, however, would seem to be for the members to hold legal title and contract for the services of the organization on a cooperative basis, or to have legal title to each unit held by a corporation as trustee for the occupant. Either plan would require separate mortgages for each unit and for that reason might be difficult to finance, especially if the mortgage is not to be insured. The plan whereby the cooperative, or a separate corporation, holds title to each unit separately as trustee must be distinguished from the trust form of organization discussed earlier. The organization holding title as trustee would not manage the project by virtue of being trustee; its only trust function would be to hold title. Management would be carried on preferably by a separate corporation, with members as the sole stockholders.⁴⁸

THE WAGNER-ELLENDER-TAFT BILL

The Wagner-Ellender-Taft Bill, if enacted as it passed the Senate at the last session of the Congress, will afford aid to groups interested in cooperative housing by: (1) providing a redevelopment program to make desirable locations, which now comprise blighted and slum areas, available for private purchase and use in accordance with redevelopment plans;⁴⁹ and, (2) offering special mortgage insurance which would be confined to areas where there is a need for new dwellings for families of lower income which cannot adequately be met by privately financed construction. This special insurance would be available for: "a mortgage with respect to (i) a project of a nonprofit mutual ownership housing corporation the occupancy

⁴⁷ HENRICKSON, *op. cit.* *supra* note 2, at 1, 3.

⁴⁸ BULL. No. 858, *supra* note 1, suggests that:

"If financing or other compelling reasons make necessary the giving of individual titles to the members, safeguards such as the following should be imposed: A recorded option whereby the association reserves the right to buy the property at any time at a stipulated price, minus depreciation computed according to a stipulated formula; a recorded agreement (embodied in the option) that no sale to any other person or organization may be made until a specified time after the association has been notified of intention to sell; an agreement that premises shall not be rented to nonmembers except with the permission of the board of directors of the housing associations and under terms specified by it, and in no case for longer than 6 months or 1 year; and provision in charter and bylaws that in the event of dissolution of the association, all property shall be sold through it, with any surplus of funds realized in excess of actual investment, minus depreciation, to be distributed in some form entailing no profits to individual members (such as by donation to housing authority or State board, or to a fund for promoting the cooperative movement)." (Page 27.)

⁴⁹ Title VI of the Wagner-Ellender-Taft Bill as it passed the Senate, 79th Cong., 2nd Sess. (1946).

of which is restricted to members of such corporation, (ii) a project constructed by a nonprofit corporation organized for the purpose of construction of homes for members of the corporation, (iii) a project undertaken by an educational or training institution (as defined in the Servicemen's Readjustment Act of 1944, as amended) primarily for the purpose of providing adequate housing accommodations for student veterans, or such veterans and their families. . . ."⁵⁰

A mortgage could be insured if it is not for in excess of 95 per cent of the estimated value of the project when completed and it could have a maturity of not over 40 years from the date of the insurance. The interest rate on such loans could not exceed 3½ per cent per year. This type of insurance would attract private capital to the high percentage financing of qualified projects for long terms at low interest rates and thus give the lower income group an opportunity to start a project with a small down payment and with lower monthly charges since repayment would be spread over a longer period of time.

CAVEAT EMPTOR

It is elementary that the primary purpose of a cooperative of any type is to provide an economical service to members by eliminating speculative profits. Yet, profit-seeking promoters have found a fertile field in so-called "cooperative apartment projects" in metropolitan areas. One method is for a promoter to organize and own all of the stock of a corporation which acquires an apartment building. The stock is allotted to apartments and sold to tenants under much the same arrangement as is found in a real cooperative except that the promoter sells the stock at whatever profit the traffic will bear. Before disposing of the stock in the "cooperative," he may contract to manage it for a generous fee.⁵¹

These and similar schemes are easily detected by remembering that the promotion of a true cooperative is not a profit-making enterprise. While a contractor who builds for a cooperative will, of course, make a profit on his contract, no person connected with the cooperative itself should be allowed to personally profit at the expense of the organization. Thus where a promoter sells stock in a so-called cooperative apartment project at 50 per cent above cost to him,⁵² if there is any "cooperation" it would seem to be rather one-sided.

⁵⁰ *Id.* §404. Sec. 406 would help establish a market for mortgages on these projects through the Federal National Mortgage Association, a corporation wholly owned by the United States. That association would also be authorized to make preliminary advances at not to exceed 3 per cent interest, to make funds needed in the formulation of the project available.

⁵¹ For an illustration of the difficulties which members of this type of "cooperative" may encounter, see *Schaffer v. 8100 Jefferson Ave. East Corp.*, *supra* note 46.

⁵² The facts recited in *50 East 75th St. Corp. v. Comm'r*, 78 F. (2d) 158 (C. C. A. 2d, 1935) show that stock costing a promoter \$67.20 per share was sold by him at an average profit of about \$31.00. See also *Schaffer v. 8100 Jefferson Ave. East Corp.*, *supra* note 46, where buildings which cost two million dollars in 1922 were in 1927 transferred subject to a mortgage of some \$1,875,000, to a "cooperative" corporation in exchange for all of its stock. The capital of the "cooperative" totaled \$2,050,000 and the promoter sold stock representing it to "tenants." Thus, by the time the tenants became stockholders of the "cooperative" the cost of acquiring the buildings was about twice what they had cost the promoter.

SUMMARY

Veterans are manifesting an interest in cooperative organizations in an effort to obtain more comfortable and more economical housing. The trust form of organization does not seem well fitted for it would afford limited liability for the members only by requiring the relinquishment of democratic control. However, the organization may be incorporated under limited dividend housing corporation laws, cooperative association laws, or non-profit or general corporation laws, depending on the law of the state, the type of project to be undertaken and the desires of the members.

A cooperative housing corporation should provide the stockholders with a greater voice in the management than is often found in the case of corporations. There is no need for proxy voting or dividends, and restrictions on stock transfers are desirable.

The corporation, if all its receipts are from members and are used for (1) expenses, (2) compulsory patronage refunds (instead of dividends), and (3) capital contributions, will incur no liability for Federal income tax. Also, if there is compliance with Section 23(z) of the Internal Revenue Code each member may deduct his share of interest and real estate taxes paid by the cooperative, in computing his taxable income.

The National Housing Act, as amended, offers insurance for a mortgage not in excess of 90 per cent of the estimated current cost of completion. The Veterans Administration has not yet announced a definite policy regarding the financing under the G. I. Bill of Rights of cooperatives composed of veterans.

A number of factors favor having legal title in the individual members or in trust for them severally, although such a plan would probably weaken the cooperative organization.

The Wagner-Ellender-Taft Bill, if enacted, would make available desirable locations in redevelopment areas and would offer more advantageous financing for mutual housing projects for lower income workers.

Cooperative housing offers promise, only if it is organized on the basis of co-operation. The cooperative is no place for the speculative promoter; high profits and management fees for him are inconsistent with the true goal of economical housing for members.