

Recent Changes To The 80/20 Rule Continue To Provide Tax Relief To Unit Owners and Opportunity to Co-op Boards

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For decades, owners of New York City co-op apartments have been entitled to an income tax deduction for their proportionate share of real estate taxes and mortgage interest so long as their buildings, or apartment corporations to be precise, were in compliance with the 80/20 rule.

In order to realize the tax deductions enjoyed by owners of single family homes and condominium units for years, co-op unit owners had to first ensure that their building qualified.

The Original 80/20 Rule

Pursuant to Internal Revenue Code Section 216 in its original form, shareholders in New York City co-ops were entitled to a tax deduction so long as the corporations received at least 80% of their gross income from tenant-shareholders and no more than 20% from other sources, most notably commercial tenants.

This so-called 80/20 rule came into being in the 1940s. The intent behind the law was to afford the same tax deductions to owners of cooperative apartments that owners of single family homes had been enjoying for years while, at the same time, preventing commercial corporations from taking advantage of the benefit. Obviously, this law had the most significant impact in New York City.

Over time, this law became burdensome for many New York City co-ops, particularly the 1,000+ which contain commercial space. The original 80/20 rule effectively limited the amount of rent that could be charged to commercial tenants which, in many cases, resulted in sweet-heart deals for tenants.

For years, this was a coup for the commercial tenant but quite onerous for the apartment corporation and its shareholders. Many co-ops with prime locations were not able to take full advantage of the market value of their commercial space. Those that did ran the risk of losing the tax deduction which in turn impacted property values of individual units in the building. In most cases, units in buildings not in compliance with the 80/20 rule were deemed less desirable by prospective purchasers.

80/20 Rule Change—New Criteria

The Mortgage Forgiveness Debt Relief Act of 2007 effectively modified the qualifying criteria for apartment corporations. Under the revised law, which became effective January 1, 2008, a tenant shareholder in a co-op apartment building would be entitled to the tax deduction so long as the corporation passes at least one of three tests:

Test 1: The first test is simply the original 80/20 rule.

Test 2: The second test requires that 80% of a building's total square footage be available for residential purposes by shareholders.

Test 3: The third test requires that at least 90% of the corporation's expenses be for the benefit of the shareholders.

In short, the qualifying bar was lowered for the co-op building and its shareholders. The additional two tests effectively made it much easier for a building to qualify. Many shareholders who were not eligible for tax deductions suddenly became eligible. Non-compliant apartment corporations suddenly became compliant.

Impact of New Law—Increased Commercial Rents Providing Apartment Corporations with Financial Flexibility

In addition to tax deductions benefitting the unit owners, the revised 80/20 continues to benefit apartment corporations throughout New York City on a much broader scale.

As commercial leases in now 80/20 compliant co-op buildings set to expire, apartment corporations have the ability to negotiate new and more favorable terms. Simply put, apartment corporations have, in many cases, been able to increase the commercial rent it collects. Those that haven't are waiting for existing leases to expire.

Slowly but surely, the new 80/20 rule is expected to eliminate a majority of the sweet-heart leases that commercial space tenants have been enjoying for so long. As the commercial market in New York City continues to improve, the impact of the new 80/20 rule should become more obvious.

Given the direct correlation between the commercial rent an apartment corporation collects and the maintenance charges a unit owner pays, the new and more flexible 80/20 rule continues to provide apartment corporations with financial flexibility.

As apartment corporations collect more from commercial space tenants, they have the ability to collect less from their shareholders (i.e. themselves) and/or increase the amount of the building's reserve fund. No matter how you interpret, lower maintenance payments and more substantial reserves result in greater market values of the individual apartments.

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