



Changes to the 80/20 Rule – Tax Relief & Potential Opportunity for NYC Co-ops

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 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 owners had to first ensure that their building qualified.

The Original 80/20 Rule

Pursuant to Internal Revenue Code Section 216, shareholders in New York City co-ops would be 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 1940's. 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 80/20 rule limited the amount of rent that could be charged to commercial tenants which, in many cases, resulted in “sweetheart deals” for tenants. For years, this was a coup for the commercial tenant but quite onerous for the housing corporation and its shareholders. Many co-ops with prime locations were not able to fully take advantage of the market value of their commercial space. Those that did ran the risk of losing the tax deduction which in turn impacted 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 housing corporations. Under the new law, which became effective January 1, 2008, a tenant shareholder in a co-op apartment building is 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. In addition, numerous corporations with commercial leases set to expire were able to significantly increase commercial rent. As a result, in many cases maintenance charges either remained steady or were reduced.

Potential Impact of New Law –Increased Property Values & Commercial Rents

Many feel that the biggest impact of the new legislation is yet to come. The reasons most commonly given are the current state of the commercial rental market in New York City and the fact that many “sweetheart leases” are not yet due to expire. Over time, as the market improves and these leases expire, co-op buildings should be able to take advantage of this rule change on a more obvious level. As the leasehold value of the commercial space increases, it is anticipated that the value of the individual units shall increase as well.