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MEMORANDUM

TO: COOPERATIVE CORPORATIONS, MANAGERS & FRIENDS

FROM: ANDREW P. BRUCKER & LLOYD REISMAN

**RE: INTERNAL REVENUE CODE SECTION 216
CHANGES TO THE "80/20 RULE"**

DATE: JANUARY 3, 2008

A new law was recently enacted that dramatically changes the application of the so-called "80/20 rule" to cooperative housing corporations.

Section 216 of the Internal Revenue Code allows tenant-stockholders to deduct their proportionate share of the mortgage interest and real estate taxes paid by a qualifying cooperative housing corporation. However, prior to the enactment of the new law, this pass-through deduction was permitted only if 80% or more of the cooperative corporation's gross income in that particular year was from its tenant-stockholders. Such income was often called "good income" by cooperative housing professionals. Thus, in a cooperative, no more than 20% (thus the name the "80/20 rule") of the gross income of the cooperative could come from other sources. Such income was often called "bad income". Bad income included rental income paid to the cooperative corporation by a commercial tenant renting a store and by professionals renting office space.

Therefore, prior to the new legislation, a cooperative housing corporation's failure to meet the requirements of the "80/20 rule" resulted in the loss of the tenant-stockholders' right to deduct the portion of their maintenance which was used for real estate taxes and interest on the cooperative's underlying mortgage for the tax year in which the cooperative failed to meet the test.

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If a cooperative failed the 80/20 rule, the choices often were limited to increasing the maintenance charges, imposing a special assessment (i.e. increasing "good income") or lowering commercial rents (i.e. reducing "bad income"). Due to the unpopularity of the first two options, cooperatives often elected to receive commercial rents that were below market value solely to guarantee 80/20 compliance.

80/20 compliance was further complicated when New York City began its tax abatement programs for cooperative stockholders. To return the tax abatement to the individual stockholders, a cooperative had to reduce maintenance charges. This had the effect of lowering the "good income," or income received from tenant-stockholders, and, consequently, would require a reduction in the amount of acceptable "bad income" to remain 80/20 compliant.

Such an arcane formula, with its harsh results, was long due for an overhaul.

In response, a new law was enacted at the very end of 2007. Now, in addition to the old "80/20 rule," there are now two additional tests by which a cooperative housing corporation may alternatively qualify for the tenant-stockholder deduction.

Cooperative housing corporations may now qualify for the tenant-stockholder deduction by meeting one or more of the following requirements:

- i. 80 percent or more of the corporation's gross income for such taxable year is derived from tenant-stockholders [THIS IS THE OLD 80/20 RULE]; or
- ii. At all times during such taxable year, 80 percent or more of the total square footage of the corporation's property is used or available for use by the tenant-stockholders for residential purposes or purposes ancillary to such residential use; or
- iii. 90 percent or more of the expenditures of the corporation paid or incurred during such taxable year are paid or incurred for the acquisition, construction, management,

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maintenance, or care of the corporation's property for the benefit of the tenant-stockholders.

As this law is new, there are obviously unanswered questions that exist. For example, in the second test, is a roof included in the total square footage of a building? And is the answer different if there are pavers on the roof to allow it's use by the tenants? Hopefully, these questions will be answered in the near future.

These changes may have a major beneficial impact on the financial situation of your cooperative corporation. This is especially true if your cooperative corporation has rental income from commercial tenants. If your cooperative corporation is party to such a lease, we strongly recommend that any such commercial lease be reviewed immediately. Assuming that your cooperative corporation is able to meet one of the new alternative qualifications provided by this new law, your coop (and the shareholders) may reap great benefits in the future.

Please feel free to contact this office with any questions you may have.