Helping a Co-op Avoid a Costly Mistake

The Problem

A co op was running up against a limitation known as the "80/20 rule" violators lose their pass through status. Pass through treatment allows a co op's shareholders to take personal tax deductions for their portion of a co op's property taxes and mortgage interest. Per the Rule, those deductions are lost if more than 20 of a co op's gross income comes from any source other than payments from its tenant shareholders. Because of the 80 20 rule, the co op was being forced to accept less than full market rents from the stores on its ground floor; the co op was losing substantial income just to keep its income from commercial tenants below the 20 threshold.

The Request

A law firm had developed a proposed method of circumventing the 80/20 rule. Mantell Advisory was asked to evaluate it.

The Analysis

The proposal had complex tax risks. Our first concern was whether it would withstand scrutiny. In addition, we questioned the degree to which the proposal would financially benefit the co-op and its shareholders, and at what costs. We also had concerns about the complexity of the structure, including the necessity to create a private Real Estate Investment Trust. The stakes were high:

If the proposal had merit, it would mean an economic windfall for the co op. But the Building would also lose control over the type of commercial tenants occupying its ground floor – no small concern given the building's prestigious location on Manhattan's Upper East Side, a fact that had not been highlighted to the Board.

If the proposal lacked merit, the negative consequences for the co op would include loss of pass-through tax status; and the reduced market values of the shareholder's apartments from the mere disclosure of that risk would be for naught.

With these possible tradeoffs in mind, we began our investigation by interviewing the lawyers who developed the proposal and reviewing all operative documents. At inception, we uncovered errors in the financial benefits analysis the lawyers had prepared – the benefits were being exaggerated. We also questioned the validity of a key property appraisal the entire approach could fail if that appraisal later was found over stated. We revised the benefits analysis, prepared a summary of the overall structure, and then arranged to make a private presentation for an evaluation of the concept before the Co op and Condominium Subcommittee of the State Bar Association's Tax Committee. A majority on the Subcommittee concluded that the proposal carried substantial tax risks and might not withstand scrutiny, although it was not certain to fail.

CONTINUED >

The Analysis (continued)
We then presented our analysis to the co-op Board. The presentation included:

- An evaluation of tax risks
- An evaluation of other complexities of the legal structure
- An evaluation of the financial and other costs and benefits to the co-op and its shareholders
- An evaluation of the feasibility of later unwinding the required transactions if the approach later failed to accomplish its original objective

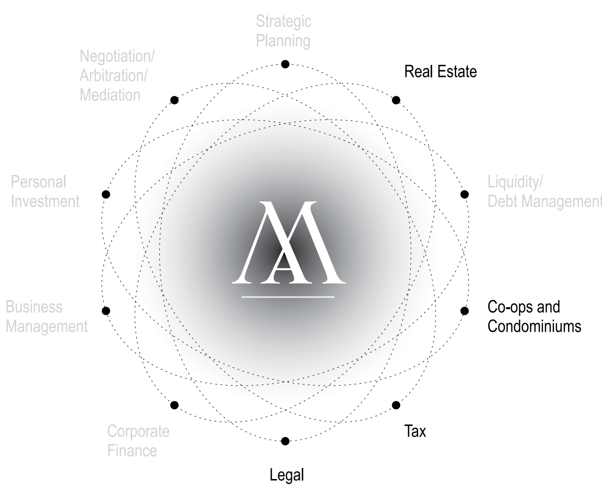
In the course of our analysis we also concluded that the 80/20 rule was likely to soon be drastically modified by federal legislation, possibly eliminating the need to take any action in order to be able to accept higher commercial rents in future.

The Results
The co op board accepted our recommendation to reject the proposal. The rule after being on the books for decades was soon afterwards revamped by legislators.

The building and its shareholders:

- Harvested the full economic value of the ground floor retail spaces
- Avoided the costs of attempting to circumvent the 80/20 rule.
- Preserved complete control over the types of commercial users occupying their ground floor.

Areas of Expertise Applied



Mantell Advisory
1430 Second Avenue, Suite 102
New York, NY 10021
T 212.755.6390
F 212.734.9195
info@mantelladvisory.com