

PROPERTY TAX PASS-THROUGH FOR HOMEOWNERS ASSOCIATIONS

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Many homeowners have asked why they can't deduct their homeowners' association dues as property taxes, since their association provides much the same services as a governmental agency. For some the question is more important when they are paying for road maintenance and trash services through their property taxes, and again through their homeowners association dues.

The IRS has long held that homeowners' association dues will not qualify as property taxes because of the private benefit element also included in the association dues. However, in a recent ruling, the IRS provided guidelines in a very narrow area in which property taxes might be considered deductible.

Private Letter Ruling 200025043 held that payments in lieu of taxes (PILOT) made by a state-created limited liability company that constructed a mixed-use building constituted a deductible real property tax. The company may deduct the payments as real property taxes under §164 because (1) the payments are measured by and are equal to the amounts imposed by the regular taxing statutes, (2) the payments are imposed by a specific state statute, and (3) the proceeds are designated for a public purpose. Therefore, the PILOT met Revenue Ruling 71-49's definition of a "tax". Accordingly, each condominium owner may deduct the payments in the amount of the stockholder's proportionate share.

The Company was created for the purpose of constructing a 39-story mixed use building subject to a land lease to a public benefit corporation created for the purpose of financing, constructing and operating a planned community development at the site. The site was originally owned by City, which executed a Master Lease to Authority. The Master Lease incorporates a master plan which governs the development of the Project Area and provides, in part, that Authority will provide municipal facilities in the site, including sewers, water lines, hydrants, parks and plazas, a waterfront esplanade, and other civic, cultural, and recreational facilities. The Authority is exempt from property tax.

“The IRS indicated that under a very special set of circumstances, property taxes paid as part of homeowners association assessments could be passed through to the individual tenant shareholders. While the ruling is so narrow that it may only be used by the subject taxpayer, it at least gives insight into the IRS’ thinking on the property tax issue.”

The Master Lease provides that each sublease of the property, i.e., of a parcel in the site, that is to be improved with housing shall provide for the payment to the public benefit corporation of the applicable amount of tax equivalency payments, which are required by law. The law provides that “If the underlying parcel is exempt from real property taxes ...the residential lease for such underlying parcel shall provide for the payment by the owner of such residential lease to the [Authority] of annual or other periodic amounts equal to the amount of real property taxes that otherwise would be paid or payable with respect to such underlying parcel, after giving effect to any real property tax abatements and exemptions, if any, which would be applicable thereto...[if the statutory provisions exempting the property from real property taxes] were not applicable to such underlying parcel.”

The tax equivalency payments that apply to building is the amount equal to the product of the assessed value of the parcel and any improvements multiplied by the City's real property tax rate, less the amount of any tax exemptions or abatements that would be available if the fee was not owned by a tax exempt entity.

The Company intends to subject its leasehold estate in the property to condominium ownership under state law and to assign to condominium purchasers leasehold interests in the apartment units and proportionate individual leasehold interests in the common elements of the buildings. Under



Property Tax Pass-Through (cont'd)

the condominium law of the State, once any part of the site becomes subject to condominium ownership the unit owners are personally liable for taxes assessed. The law requires common expenses to be charged to the unit owners according to their respective common interests.

The Site Lease provides that the common charges include a rental payment, part of which is PILOT. The amount of PILOT is equal to the tax equivalency payments as defined and adjusted in the Site Lease. After the property is converted to condominium ownership a board of managers designated or elected by unit owners will administer the affairs of the condominium including the determination of common charges. The common charges will be payable by each unit owner to the board of managers. The board of managers in turn is required to pay the rental due under the Site Lease to Authority. The Master Lease and the Site Lease thus provide the collection vehicles for the tax equivalency payment and corresponding PILOT obligations which are, however, authorized and imposed under specific statutory authority.

The tax law analysis section of the Ruling stated “Section 164 allows as a deduction the state, local and foreign real property taxes paid or accrued in the taxable year. Section 1.164-3(b) of the Income Tax Regulations defines real property taxes as taxes imposed on interests in real property that are levied for the general public welfare. Assessments for local benefits are not treated as real property taxes. See §1.164-4.”

“Whether a particular charge is a tax within the meaning of §164 depends on its true nature as determined under federal law. The designation given by local law is not determinative. A charge will constitute a tax if it is an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenues to be used for public or governmental purposes. Rev. Rul. 71-49, 1971-1 C.B. 103; Rev. Rul. 61-152, 1961-2 C.B. 42. Rev. Rul. 71-49 involved tax equivalency payments to the New York City Educational Construction Fund, a public benefit corporation, by a cooperative housing corporation. The payments were applied to debt service on obligations funding public school construction. The ruling holds that the cooperative housing corporation may deduct the payments as real property taxes under §164 because (1)

the payments are measured by and are equal to the amounts imposed by the regular taxing statutes, (2) the payments are imposed by a specific state statute (even though the vehicle of a lease agreement is used), and (3) the proceeds are designated for a public purpose rather than for some privilege, service, or regulatory function, or for some other local benefit tending to increase the value of the property upon which the payments are made. Accordingly, each tenant-stockholder of the cooperative housing corporation may deduct the payments in the amount of the stockholder’s proportionate share.”

“The PILOT obligations in this case also satisfy the three-prong test of Rev. Rul. 71-49: (1) PILOT are imposed at the same general rate at which real property taxes are imposed; (2) PILOT are imposed by state statute although the law uses the vehicle of leasing agreements; and (3) PILOT may only be used by Authority for public purposes, including debt service of bonds issued to construct municipal facilities and services, and payment of operating and administrative expenses.”

As a result of this analysis, the IRS ruled that:

“1. The PILOT obligations to be made pursuant to the Site Lease to Authority (or to City should it reacquire the Project Area) constitute real property taxes allowable as a deduction to the payor under §164.”

“2. Following the submission of the leasehold estate in the property to condominium ownership, Taxpayer as a unit owner will be entitled to deduct as real property taxes under §164 the portion of the common charges that Taxpayer pays to the board of managers and that are applied by the board of managers to the PILOT obligations.”

While this ruling is so narrow as to be unusable by anyone other than the subject taxpayer, the ruling does provide additional insight into the IRS’ current thinking on the property tax issue.

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