Cooperative Ownership And The Mortgage Interest Deduction

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With respect to the Presidential election and the candidates, there has been discussion about doing away with the mortgage interest deduction. The mortgage interest deduction allows a homeowner to deduct interest on home mortgages up to $1 million in value. President Obama has made clear that he wants to keep the mortgage interest deduction in place, though he has proposed making it available only for taxpayers making less than $250,000.[1]

Romney's position on the future of the mortgage interest deduction is less clear. In his most recent interview on the subject, Mitt Romney stated that, "As an option, you could say everybody's going to get up to a $17,000 deduction. And you could use your charitable deduction, your home mortgage deduction, or others — your health care deduction, and you can fill that bucket, if you will, that $17,000 bucket that way. And higher income people might have a lower number."[2] Such a proposal indicates that a change could come to the mortgage interest deduction should Romney win the election.

Importantly, the mortgage interest deduction is regressive in nature. In order to be eligible, the taxpayer must itemize deductions. As taxpayers in higher tax brackets are more likely to itemize their deductions, the mortgage interest deduction tends to favor those in higher brackets.[3] The deduction also favors those with larger mortgages. The average value of the mortgage interest deduction for those with an annual income of less than $40,000 amounts to $91, compared to an average value of $5,459 for those with an annual income over $250,000.[4]

For those living in higher income areas, with higher home prices, like New York City, the deduction will be much more valuable. The situation is further complicated by the amount of foreign investment in the New York City housing market. Foreign investors may be eligible for the mortgage interest deduction if they make a Section 871(d) election to treat a passive rental real estate investment as a U.S. trade or business. Otherwise, taxes would be classified under the withholding tax regime, which does not allow for deductions.[5]

The connection between the mortgage interest deduction and the New York City real estate market is compounded by §216 of the Internal Revenue Code, or the '80/20' rule. The 80/20 rule seeks to ensure that cooperative housing corporations are operating as residences and not as businesses. If §216 is satisfied, a cooperative is allowed to take the interest deduction on the building's mortgage and the cooperative's shareholders are also allowed to deduct their proportionate share of the underlying building's mortgage interest and real estate taxes. In effect, § 216 allows for a double deduction. As Congress didn't want businesses to take advantage of this double deduction, buildings have to meet one of three requirements in order to qualify.

Under § 216, tenant-shareholders are permitted to deduct their proportionate share of the underlying building's mortgage interest and real estate taxes if either 80% of the corporation's income is from tenant-shareholders or 80% of the square footage is available for residential purposes. Alternatively, 90% of the corporation's expenses need to benefit tenant-shareholders in order for the tenant-shareholder's to take the permissible deductions.

Accordingly, the question raised for New Yorkers by the election discussions is not just what would happen to the real estate market if we did away with the mortgage interest deduction, but what would happen to cooperative ownership should the deduction cease to exist in its current state. Would removing the mortgage interest deduction incentivize cooperatives to disregard the 80/20 rule? Similarly, questions are raised as to the impact on New York City property values. Without having to comply with the 80/20 rule, cooperatives could change their ownership schemes to favor commercial tenants and potentially increase revenue and reserves. This could decrease monthly maintenance charges while at the same time improve the fiscal health of buildings thereby improving property values.

However, any savings individual owners would have on their monthly maintenance payments would be offset by the impact of the loss of the deduction to tenant-shareholders. In New York, as opposed to other real estate markets around the country, the deduction holds real monetary value for homeowners. It is possible that any drop in property values due to the loss of the individual owner's deduction would be offset by the cooperatives' ability to increase revenue free from the restrictions of the 80/20 rule.

Accordingly, New York's reliance on cooperative ownership paints the election debates in a different light then the rest of the country. While it is difficult to predict the exact outcome of removing the deduction on New York property values, it is safe to assume that cooperative ownership would certainly feel an impact.

[1]Byron Tau, "Obama Rules Out Eliminating Home Mortgage Deduction," *Politico* (Sept. 27, 2012), available at http://www.politico.com/politico44/2012/09/obama-rules-out-eliminating-home-mortgage-deduction-136854.html

[2]Associated Press, "Romney: $17K Tax Deduction Lid a Possible Route," CBS News (Oct. 3, 2012), available at http://www.cbsnews.com/8301-250_162-57524964/romney-$17k-tax-deduction-lid-a-possible-route/.

[3]Harris & Baneman, "Who Itemizes Deductions?," *The Tax Policy Center* (Jan. 17, 2011), available at http://www.taxpolicycenter.org/UploadedPDF/1001486-Who-Itemizes-Deductions.pdf.

[4]Toder, Turner, Lim, & Getsinger, "Reforming the Mortgage Interest Deduction," The Tax Policy Center (April 2010), available at http://www.taxpolicycenter.org/uploadedpdf/412099-mortgage-deduction-reform.pdf.

[5]Raasch & Amitrano, Jr., "Guide to U.S. Income Taxation of Foreign Nationals," available at http://www.borelassociates.com/topics/Guide%20to%20U.S.%20Income%20Taxation%20of%20Foreign%20Nationals.pdf.

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