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Co-ops Reap Unexpected Bonanza

By [VIVIAN S. TOY](#)

FOR years, some [New York City](#) co-ops that have retail space in their buildings have been doing the unfathomable. They have rented out their commercial space at bargain rents, and to make sure they weren't making too much money on the spaces, they have even occasionally given back thousands of dollars to tenants at the end of the year.

They have done so because of the 80-20 rule, a federal tax regulation that requires residential co-ops to get at least 80 percent of their gross income from tenant-shareholders and no more than 20 percent from other sources like commercial tenants.

But a change in the law modified those rules late last year, and co-op boards are now busy making sure they are getting every penny possible from their commercial space.

"This change will be a bonanza for co-ops with retail space," said Richard Siegler, a [Manhattan](#) co-op and condominium lawyer. "Co-ops will be able to take in additional income, but the real beneficiaries will be shareholders, because now that buildings can pay expenses with rental income from commercial spaces, shareholders will get lower maintenance charges."

Before the change in the law, buildings that fell off what was known as the "80-20 cliff" would lose their legal status as co-ops, and shareholders would lose the tax benefits granted to homeowners. But the new rules essentially allow all co-ops to keep their tax benefits without giving up rental income or going through financial and legal gyrations to stay on the safe side of the 80-20 rule.

Some brokers see benefits from the changes beyond the here and now. Richard Grossman, the executive director of downtown sales for Halstead Property, said that buildings would be able to pay for a high level of service without raising maintenance fees and that this "translates into higher values for the apartments."

Mr. Grossman said that when he was the board president at his Greenwich Village co-op, the building routinely had to forgo as much as \$100,000 a year in commercial rent. "Everything now is going to be much cleaner, and the income potential for buildings is much higher," he said.

Brokers and real estate lawyers estimate that roughly 1,000 co-ops throughout the city have rentable commercial space like stores and parking garages. As leases expire and rents rise, the changes in retailing will probably be the most noticeable. Stuart M. Saft, a real estate lawyer and the chairman of the Council of New York Cooperatives and Condominiums, said more national chains might move in and displace mom-and-pop stores.

Buildings that were trying to keep their commercial income down "may have chosen a tenant they had a personal relationship with or they liked," he said, "because they knew they couldn't get the maximum rent, but now it's going to go to whoever can pay the highest rent."

Under the new law, co-ops need to pass one of three tests so that shareholders can qualify for tax benefits, including deductions for property taxes and mortgage interest and the right to shield up to \$500,000 from capital-gains taxes when the apartment is sold. The original 80-20 rule is one test. The

second requires at least 80 percent of a building's total square footage be available for use for residential purposes by tenant shareholders. And the last is for a co-op to spend at least 90 percent of its total income for the benefit of shareholders.

Real estate lawyers and brokers agree that all but a handful of the city's co-ops will be able to pass at least one of those three tests. They also note that while the new law will have the biggest impact in New York City, where co-ops make up 75 percent of the nonrental apartment stock, other cities that have co-ops, like Chicago and [Los Angeles](#), will also benefit.

The 80-20 rule was created in the early 1940s when Congress sought to give co-op residents property-tax deductions but wanted to keep commercial corporations from taking advantage of the tax benefits. It is only in the last 10 to 15 years that commercial rents have risen to a level to make the rule a challenge for many New York co-ops.

“Especially in the last five years, rents have shot up so much that a co-op that was going to lie down and play dead wouldn't do it anymore, so they had to come up with ways to skirt the law,” said Benjamin Fox, president of the Winick Realty Group, a brokerage that specializes in retail space.

On the Upper East Side, for example, retail rents have gone from about \$150 a square foot annually in 2002 to as much as \$300 a square foot, he said. For a 2,000-square-foot clothing or shoe store, that means that the monthly rent has doubled, rising from \$25,000 to \$50,000.

At 165 East 72nd Street, a 180-unit co-op with six commercial tenants, the co-op board grappled with the 80-20 rule when new leases produced an additional \$1 million a year in rents and pushed its “bad income” well beyond 20 percent. Stanley Schlesinger, the board president, said the co-op had considered selling off some of the property or creating a subsidiary corporation made up primarily of shareholders.

“But the problem with all that is they're very complicated deals, you need to have a lot of tenants voting for it, and you lose some control of your property,” he said.

The board ultimately decided to fall off the 80-20 cliff and give up its tax benefits and had already informed shareholders of the plan when the new law went into effect on Dec. 20, pulling the building back from the precipice.

“We were pleased with what we did at the time,” Mr. Schlesinger said. “And in hindsight, we're even more pleased, because now we can still comply with the law and maintain our status.”

The new law also brought great relief to the co-op board at 101 West 12th Street, which had been negotiating with Con Ed to convert to bulk billing for its electricity — instead of having the utility charge its apartment owners individually — so it could add those charges to maintenance fees, thus increasing the amount of its income derived from its shareholders.

(The building had also explored bulk billing for cable services but concluded it would be too complicated, because bulk rates were available only for basic cable service, and its residents tend to have very individualized cable plans.)

The building has 410 apartments and seven stores, and its commercial rent exceeded 20 percent of its income. Frank Saracino, the board president, said the co-op had reluctantly explored the Con Ed option as a way to increase its “good income.”

“We really didn't want to be in the electricity business,” he said. “There would have been no benefit to the building, but it was something we were going to have to do.” The timing of the change in the law couldn't have been better, he added.

His building might have negotiated a new lease differently if the law had taken effect earlier. Starbucks

recently offered to pay about \$190 a square foot annually for a space in the building, but the board chose a tenant that pays about \$150 a square foot.

“There were other issues involved, like whether you want food in the space, but we couldn’t go after the bigger-ticket item because of 80-20, and we were forced to accept a tenant that paid lower rent,” Mr. Saracino said. “If the money had been a slam-dunk, it might have been a different conversation.”

While many of the buildings that will benefit from the new law are luxury apartment buildings, Penn South, a 15-building complex for middle-income residents in Chelsea, also stands to gain.

Brendan Keaney, general manager of Penn South, said that when the complex, which extends from 23rd to 29th Streets between Eighth and Ninth Avenues, was built in the early 1960s, it was intended to provide inexpensive housing for garment workers, and it still has income restrictions for its residents.

At the time of construction, there were so few amenities in the area that the developers built about 30 retail spaces to provide stores and services like a supermarket and a dry cleaner. Chelsea has since evolved into a thriving area, and there has been no shortage of potential tenants, retail and residential, at Penn South.

Mr. Keaney said that retail rents had not yet exceeded 20 percent of the complex’s income, but were coming close. He said that with the change in the law, Penn South may hire a consultant to “see if we’re using the commercial space to the highest and best use, and we might be a little bit more adventurous in what we do.”

Any additional retail income would help subsidize the housing corporation, he said, and that will help perpetuate the original intent of Penn South “to have a schoolteacher or city employee be able to live in Manhattan and have affordable housing.”

Building managers, real estate lawyers and accountants agree that one thing is certain: the new law has made hundreds of co-ops very happy.

“The things that buildings have had to do to keep their tax status have been an administrative nightmare, and this removes a cloud over regular operations,” said Paul Gottsegen, the director of property management at Halstead Property.

The law merely helps to assure that co-op owners will continue to receive the same tax benefits as the owners of condos and single-family homes. “This is a recognition that even if a co-op collects some income, it wasn’t designed to be a money-generating investment,” he said. “A co-op is a co-op — it’s a place where people live.”