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December 8, 2011

William J. Wilkins, Chief Counsel
Office of Chief Counsel
Internal Revenue Service
1111 Constitutional Avenue NW, Ste 3026
Washington, DC 20224

Dear Mr. Wilkins:

We are attempting to provide clarity to California taxpayers regarding the itemized deduction for real property taxes on Schedule A (Form 1040). California law conforms to federal law with respect to the deduction for real property taxes under Internal Revenue Code (IRC) section 164(a)(1).

The 2011 Instructions for Schedule A (Form 1040) regarding the deduction for real property taxes states that amounts are deductible on Schedule A "only if the taxes are based on the assessed value of the property." (2011 Instructions for Schedule A, Page A-5.)

However, a tax practitioner organization has provided the Franchise Tax Board and California tax practitioners with a copy of the enclosed Internal Revenue Service (IRS) Office of Chief Counsel Memorandum dated November 24, 2003. Within this memorandum an attorney with IRS Chief Counsel, Small Business/Self-Employed, Area 7 (CC:SBSE:7:SAC:1) authored a lengthy analysis concluding, in part, "'Mello-Roos' and other California assessments may be deductible as real property taxes, even though they are not imposed upon an 'ad valorem' basis." The last sentence of the memo indicates "[t]his advice was reviewed by the Associate Chief Counsel, Income Tax and Accounting, Branch 3."

We conducted a thorough review of all applicable federal law, regulations, rulings, cases, and guidance regarding the issue of whether or not a real property tax must be *ad valorem* to be deductible as an itemized deduction. We found that published authority, including federal legal analyses,¹ rulings,² regulation,³ case law⁴ and guidance to taxpayers,⁵

¹ General Counsel Memoranda 37927 (1979). See also General Counsel Memorandum 36466 (1975).

² Rev. Rul. 80-121, 1980-1 C.B. 44 (1980). Although not cited as precedent, see also Private Letter Ruling (PLR) 8033022, May 20, 1980.

³ Treas. Reg. §1.164-4(a).

⁴ *Sandy Lake Road Limited Partnership v. Commissioner*, (1997) TC Memo 1997-295.

supported a conclusion that the federal position is that the deduction for real property taxes is limited to those taxes that are based on the assessed value of the property.

As the 2003 memorandum directly contradicts the latest IRS instructions to Schedule A (Form 1040), and tax practitioners are citing the 2003 memorandum as authority for the deductibility of non-*ad valorem* real property taxes, we request clarification from the Chief Counsel as to whether the 2003 memorandum reflects the current views of the Office of the Chief Counsel or the IRS.

Thank for your attention to this matter.

Sincerely,

Geoffrey R. Way
Chief Counsel

Enclosure: Office of Chief Counsel Memorandum dated November 24, 2003

⁵ 2011 Instructions for Schedule A (Form 1040), page A-5; Publication 17 (2011), page 150; and Publication 530 (2011), page 2.

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB:7:SAC:1:POSTF-121032-03
[REDACTED]

date: NOV 24 2003

to: [REDACTED]
[REDACTED]
[REDACTED]

North Highlands, CA

from: [REDACTED] Attorney
Small Business/Self-Employed, Area 7 (CC:SBSE:7:SAC:1)

subject: Deductibility of California's "Mello-Roos" Taxes

This is in response to your request for advice concerning the deductibility of certain items included in California real property tax bills.

ISSUES

1. Can California "Mello-Roos" and other assessments be deductible as real property taxes, even though they are not imposed upon an "ad valorem" basis?
2. Can "Mello Roos" taxes and certain other items (sometimes described as "special assessments" or "special taxes") which appear on county real property tax statements in California be deducted as real property taxes if the properties subject to these items are the only properties benefited?

CONCLUSIONS

1. "Mello-Roos" and other California assessments may be deductible as real property taxes, even though they are not imposed upon an "ad valorem" basis.
2. Items included on county real property tax statements, whether Mello-Roos taxes, special taxes, or special assessments, are not deductible as real property taxes if the assessment specifically benefits only the property against which the assessment is made.

FACTS

Revenue agents and tax examiners in the Sacramento post of duty have been assigned to conduct audits under the National Research Program (NRP), to measure reporting compliance. These issues arose in NRP examinations, with inconsistent outcomes. As a result, SBSE Compliance requested advice from Counsel.

It is common practice in California for a variety of assessments, in addition to ad valorem real property taxes, to appear on the bill which the county assessor sends to California homeowners. Those other assessments vary from Mello-Roos "taxes" to "special taxes" to "special assessments" to sewer, garbage, and similar personal benefits. You asked us to advise whether such items are deductible, or whether some are deductible and some are not, or whether no assessments other than ad valorem assessments are deductible.

In 1978 California voters passed Proposition 13, which amended the California constitution and imposed limits on the ad valorem real estate taxes which could be imposed on owners of California real estate. Article XIII A, section 1, subdivision (a), California Constitution. Under Proposition 13, the county real property tax is limited to one percent of the net assessed value of the property, plus assessment bonds or fees approved by popular vote. The rate of tax cannot increase by more than two percent per year. The property can be reappraised only after new construction, a change in ownership, or certain declines in value. Neither the Legislature nor cities, counties or special districts may impose new ad valorem property taxes. Article XIII A, sections 3 and 4, California Constitution.

After Proposition 13, localities which wished to raise additional funds for public facilities and services (such as police protection, fire protection, ambulance and paramedic services, library services, maintenance of parks and open space, flood and storm protection, and hazardous waste cleanup and removal) were forced to raise funds outside of the traditional property tax system.

The California legislature enacted the Mello-Roos Community Services Act of 1982, Cal. Govt. Code §§ 53311-53358.3, in response to this funding problem. The Mello-Roos Act provides a method to fund certain public facilities and services through "community facilities districts." As defined in the Act, Mello-Roos is a "special tax," and not an ad valorem tax. Cal. Govt. Code § 53325.3. Mello-Roos is generally assessed at a flat rate and does not vary with the value of the parcel (although we are

advised that there may be some variation based upon the size of a lot, rather than overall value of the property as improved).

In addition to Mello-Roos, California law allows for "special assessments," "special taxes," and other assessments which appear on the property owner's annual real property tax bill along with the normal real property tax. These other charges are not limited by Proposition 13 because they are not "ad valorem" taxes based upon the assessed value of the property. The California county which issues the real property tax statement in most cases has no control over these other charges or over the agencies which levy the charges.

DISCUSSION

State and local "real property taxes" are deductible in computing federal income tax. I.R.C. § 164(a)(1). No deduction is allowed, however, for taxes assessed against "local benefits of a kind tending to increase the value of the property assessed" except for amounts properly allocable to maintenance or interest charges. I.R.C. § 164(c)(1). The term "real property taxes" means taxes imposed on interests in real property and levied for the general public welfare, but it does not include taxes assessed against local benefits. Treas. Reg. § 1.164-3(b). Taxes for local benefits, such as streets, sidewalks, and other like improvements, are not deductible when they provide a benefit inuring directly and primarily to the property against which the assessment is levied (even though there may be an incidental benefit to the public welfare). Treas. Reg. § 1.164-4(a). "The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction." Id.

As to personal property taxes (as opposed to real property taxes), the Internal Revenue Code explicitly states that, to be deductible, a personal property tax must be "an ad valorem tax imposed on an annual basis in respect of personal property." I.R.C. § 164(b)(1) (Emphasis added). But nowhere in the Code or regulations does it state that, to be deductible, real property taxes must be ad valorem taxes (or that they must be imposed annually).

Must deductible real property taxes be "ad valorem" taxes?

Some examiners have opined that, to be deductible, a real property tax must be measured by the value of the real property.

If that is the case, then California's Mello-Roos taxes are not deductible because, under the terms of the Mello-Roos Community Services Act of 1982, the Mello-Roos assessments do not vary directly with the value of the parcel.

At first blush, there appears to be support for the proposition that only ad valorem real property taxes are deductible. In Revenue Ruling 80-121, 1980-1 C.B. 44, the Service analyzed whether a "land gains tax" imposed under Vermont law on certain gains from the sale or exchange of certain land in Vermont was deductible as a real property tax or as a state income tax under I.R.C. § 164. The Service stated as follows in Rev. Rul. 80-121:

Some of the characteristics of a tax imposed on real property or on an interest in real property are: (1) the tax is generally imposed or triggered by the ownership of real property and not the exercise of one or more of the incidents of property ownership, such as use or disposition, (2) the tax is measured by the value of real property, and (3) liability for the tax is not solely personal. Rev. Rul. 75-558, 1975-2 C.B. 67, and Rev. Rul. 73-600, 1973-2 C.B. 47. (Emphasis added.)

The Service concluded that the Vermont land gains tax was not a deductible real property tax because it was triggered not by the ownership but rather by the sale of the property. (The Service did not address in the ruling the other factors contained in Rev. Rul 73-600 since the first issue was dispositive.)

In Private Ruling 8033022, 1980 PRL LEXIS 2561, the issue was whether a \$100 "annual special real property service charge" levied annually on each parcel of land in New Orleans was a deductible real property tax under I.R.C. § 164(a)(1). In analyzing the issue, the Service focused on the term "like rate" in Treas. Reg. § 164-4(a), cited above. ("The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction.") In PRL 8033022, the Service observed that neither the Code nor the regulations define "like rate." Without discussing it in any detail, the Service cited Rev. Rul. 80-121 for the proposition that a deductible real property tax must be measured by the value of real property, and concluded that, because the New Orleans annual assessment did not vary with the values of different parcels, the \$100 per-parcel assessment was not a deductible real property tax.

Notwithstanding the three-prong test enunciated in Rev. Rul. 80-121, the Service set forth a two-prong test in a 1984 Private Letter Ruling (without mentioning Rev. Rul. 80-121). See Private Ruling 8417020, 1984 PLR LEXIS 5399. In that ruling, an issue was whether a license tax and a map approval fee paid to the city, and a school facilities fee paid to the school district and imposed only on new construction in the city were deductible real property taxes. The Service stated in PLR 8417020 as follows:

In order for real estate taxes to be deductible under section 164 of the Code, they must meet a two prong test. First, the tax must be levied for the general public welfare and, second, the tax must be levied at a like rate against all property.

Because none of the assessments in question were levied at a like rate against all property (they all applied only to new construction), the Service concluded that they were not deductible real property taxes. Unlike Rev. Rul. 80-121, the language in PLR 8417020 mirrors the language in the regulations; it does not state that a deductible real property tax must be measured by the value of the property.

As stated above, Rev. Rul. 80-121 cites Rev. Rul. 75-558 and Rev. Rul. 73-600 in support of its 3-prong test (which includes a requirement that the tax be measured by the value of real property). But Rev. Rul. 75-558 and Rev. Rul. 73-600 do not directly support the proposition that, to be a deductible real property tax, the tax must be "measured by the value of real property." Those rulings hold only that a tax imposed on rents is not a real property tax, because the tax is on the use of property rather than on or against the real property or interests in real property.

As stated previously, Treas. Reg. § 1.164-4(a) provides, in part, that deductible real property taxes are levied for the general public welfare "at a like rate" against all property in the territory over which the taxing authorities have jurisdiction. One could argue that this language means substantially the same thing as "ad valorem tax." However, in section 164(a), deductible taxes are listed: (1) real property taxes, (2) personal property taxes, (3) income taxes, (4) generation skipping taxes, and the § 59A environmental tax. Then, in § 164(b), the Code contains definitions, beginning with the definition of personal property taxes at § 164(b)(1): Personal property tax means only an ad valorem tax imposed on an annual basis. If Congress had intended that both real property taxes and personal property taxes were to be limited to ad

valorem taxes, it could easily have included a definition of real property tax in § 164(b) which imposed such a limitation. Congress did not define "real property taxes" in that section.

The only reference in the Code or regulations to any requirement that a deductible real property tax must be based upon the value of the property is the phrase "at a like rate" in Treas. Reg. § 1.164-4. But the requirement that a deductible tax must be one levied "at a like rate" against all property in the territory could be interpreted to include a tax which is imposed "at a like rate" per parcel, or "at a like rate" per property owner, and not necessarily "at a like rate" per dollar of value of the property.

Because the Code limits deductible personal property taxes to ad valorem taxes, but does not so limit real property taxes, we conclude that Mello-Roos taxes and "special taxes" in California may be deductible, even though not based on the value of the property assessed. However, to be deductible, they must be assessed at a like rate against all the property in the jurisdiction. (See Rev. Rul. 77-29, 1977-1 C.B. 44, for an example of a tax which is not imposed at a "like rate.") Can other California "Special Taxes" and/or "Special Assessments" be deducted as real property taxes?

As pointed out above, under California law "special assessments" generally are assessments against specific properties based upon benefits conferred upon those properties.

I.R.C. § 164(c)(1) specifically denies deduction for a tax "assessed against local benefits of a kind tending to increase the value of the property assessed," except to the extent that the tax is allocable to maintenance or interest charges. (Insofar as assessments against local benefits are made for maintenance or repair or to meet interest charges with respect to the local benefits, they are deductible. The burden is on the taxpayer to show the amounts properly allocable to the maintenance, repairs, and interest. Treas. Reg. § 1.164-4(b)(1).)

Under the specific provisions of I.R.C. § 164(c), a California "special assessment" which is imposed based upon a benefit conferred upon the property is not deductible. In County of Fresno v. Malmstrom, 94 Cal. App. 3d 974, 156 Cal. Rptr. 777 (1979), a California Court of Appeal considered whether assessments levied on specific properties under the Improvement Act of 1911 or the Municipal Improvement Act of 1913 violated California's Proposition 13 (Article XIII(a) of the California Constitution). The Court of Appeal opined that, in adopting

Proposition 13, "a major thrust [was] controlling ad valorem property taxes." Id. 94 Cal. App. 3d at 980, 156 Cal. Rptr. at 780. The court noted that the "improvement" taxes at issue in the case were "more in the nature of loans to property owners for improvements benefiting their property," than of taxes based upon the value of the properties. Id. 94 Cal. App. 3d at 981, 156 Cal. Rptr. at 781.

The Malmstrom court found that the taxes at issue were "special assessments" and that "[i]nherent in the concept of special assessments is the fact that certain property owners receive special benefits. Id. This definition seems to place "special assessments" in California squarely within the type of taxes "for local benefits of a kind tending to increase the value of the property assessed" which are nondeductible under § 164(c)(1).

However, "special taxes" in California may or may not benefit a specific property. "A 'special tax' is a tax collected and earmarked for a special purpose, rather than being deposited in a general fund." County of Fresno v. Malmstrom, supra, 94 Cal. App. at 983, 156 Cal. Rptr. at 782-783 (citations omitted).

Thus, the deductibility of "special taxes" will depend upon an analysis of facts and circumstances.

The same holds true for Mello-Roos taxes. Although Mello-Roos taxes are not automatically non-deductible merely because they are not "ad valorem" taxes, they nonetheless may be non-deductible if they benefit and tend to increase the value of specific properties as opposed to benefiting all properties in the jurisdiction. Assessments for local benefits are not deductible as taxes. No deduction for taxes is allowed for assessments to pay for local benefits such as streets, sidewalks, and other like improvements, if the assessments are imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied. If only the property being benefited is subject to the tax, then the tax is considered as being assessed against local benefits. Treas. Reg. § 1.164-4(a); Rev. Rul. 76-45, 1976-1 C.B. 51; Rev. Rul. 74-52, 1974-1 C.B. 50.

This advice was reviewed by the Associate Chief Counsel, Income Tax & Accounting, Branch 3.