Vermont Department of Taxes
TECHNICAL BULLETIN

CHAPTER: CHAPTER 154, HOMESTEAD PROPERTY TAX INCOME SENSITIVITY ADJUSTMENT TB-28[1]

ISSUED February 6, 2004

SUBJECT: DETERMINATION AND CALCULATION OF RENT CONSTITUTING PROPERTY TAX IN NON ARMS-LENGTH TRANSACTIONS
32 V.S.A § 6071

This bulletin clarifies the factors used by the Vermont Department of Taxes to determine when a rental transaction should be deemed to be a "non arms-length" transaction and the procedures applicable to calculating rent constituting property taxes in non arms-length transactions.

The Homestead Property Tax Income Sensitivity Adjustment Program is a tax credit program available to both homeowners and renters. 32 V.S.A. §§ 6061 *et seq.* For renters, the program takes the form of a credit against income tax liability "equal to the amount by which rent constituting property taxes upon the claimant's homestead" exceeds a specified percentage[2] of the claimant's household income. 32 V.S.A. §6066(b).

A claimant may calculate, "rent constituting property taxes" as either:

(a) 21% of the gross rent actually paid for the right of occupancy (allocable rent method);
or
(b) That portion of the gross rent actually paid for the right of occupancy that is equal to the property tax assessed during the calendar year that is allocable to the claimant's rental unit for the period rented by the claimant (allocable property tax method).
32 V.S.A. §6061(7).

When a rental is deemed by the commissioner to be a non arms-length transaction, however, the Commissioner has the authority to examine the transaction to determine what portion of the rent shall be considered as rent constituting property taxes. *Id.* 32 V.S.A. § 6071(c).

The determination of whether a transaction should be deemed a non arms-length transaction is a factual determination that must be made on a case-by-case basis. An arms-length transaction is a transaction negotiated between unrelated parties in which each party is acting in his or her own best interest. *See, e.g., Barrett/Canfield, LLC v. City of Rutland,* 171 Vt. 196,

[1] 2010 Act 160, sec. 24 eliminated the option to calculate a renter rebate using the allocable property tax method. Therefore this bulletin has limited relevance to claims filed after 2010.

[2] The percentage is 3.5, 4.0, 4.5 and 5.0 depending upon household income.

198 (2000)(an "arms-length" transaction is voluntary, generally takes place in an open market, and one in which the parties act in their own best interest.). Arms-length transactions are generally considered to establish “fair market values” for sales and rentals. *Id.*

Although each transaction must be examined on its own facts to determine whether it is a non arms-length transaction, certain factors are generally indicative of a non arms-length transaction. These factors include but are not limited to:

1) the lease transaction is not voluntary on the part of one of the parties;
2) the lessor and lessee are related to each other by consanguinity, marriage, or close prior social or business relationships;
3) the negotiated rent amount is not comparable to fair market value rents paid for similar properties.

A landlord in an arms-length transaction is presumed to charge rent based upon fair market factors, including a profit motive, and is expected to charge rent sufficient to pay any and all expenses that he or she will incur such as property taxes, repairs and mortgage costs. On the other hand, a transaction that is not arms-length is typically not based on market factors.

A typical example of a non arms-length transaction is one between family members in which the decision of what rent to charge may be influenced by non market factors. The rent that is charged may not cover all of the expenses incurred by the landlord. Rental rates that are significantly below market rent have two effects on the equities of the renter rebate program.

First, because of the reduced rent, more of the tenant’s household income is available for other purposes. This allows the tenant to enjoy an effective household income that is higher than a similarly situated individual paying market rates for rent.

For example, take the situation of two individuals who each have $25,000.00 in household income and who live in two identical houses owned by the same landlord. One of these individuals is paying a fair market rent of $800.00 per month ($9,600.00 per year) while the other is paying only $200.00 per month ($2,400.00 per year) because the second individual is renting the house from a parent. After paying rent, the unrelated person would have $15,400.00 left for other purposes while the person renting from his or her parents would have $22,600.00 left after rent. The person whose rent is $200.00 per month would have $7,200.00 per year more to spend, yet would receive the same rebate. This is the inequity that section 6071 (c) is intended to address.

In addition, in non arms-length transactions, the ratio of rent to property taxes becomes skewed, creating inequities in the use of the “allocable property tax method”. In an arms-length transaction, the amount of property tax assessed is merely one factor considered in the amount of rent charged. Thus, the ratio of property tax to rent paid is typically somewhat comparable to the 21% flat rate used in the “allocable rent method”. But, in a non arms-length transaction with reduced rent, the ratio of the property tax to the rent increases and is disproportionate to the flat rate used in the “allocable rent method”.

Using the above example, assume that the property tax on each house is $2,400.00. For the individual paying market rent, the property tax is only one quarter of the rent charged, giving the landlord a source of income to pay the other expenses on the property and to make a profit. On the other hand, in the non arms-length transaction, the rent paid is equal to 100 percent of the property tax leaving no rent available to pay any other expenses. It is not equitable to assume that in a non arms-length transaction, the entire amount of the rent goes to pay the property tax while any other expenses on the property are paid from other sources.

Because a non arms-length transaction creates inequitable treatment between similar taxpayers, particularly with regard to claims involving one or two unit properties, the "allocable property tax method" of calculating rent must be adjusted to reflect the nature of non arms-length transactions. The method used to make this adjustment is as follows:

> The allowable rent paid as property tax is the amount assessed for property taxes allocable to the rental unit occupied by the tenant for the calendar year multiplied by the amount actually paid during the year for the right of occupancy of the property divided by 85% of the fair market rent as determined by the Federal Department of Housing and Urban Development pursuant to Section 8(c)(1) of the United States Housing Act of 1937 for similar property in the geographic area.

This adjustment allows that percentage of allocable property tax equal to the ratio that the actual rent paid bears to the fair market value rent for the property to be claimed. Thus, if the actual rent paid in a non arms-length transaction was 25 % of the fair market rent for the property, the tenant would be limited to claiming 25 % of the allocable property tax as well. The claimant would still be permitted to base his or her claim on 21% of the amount actually paid in rent during the year if that calculation results in a higher claim.

This adjustment requires the following steps:

1) Determine the actual amount of property tax assessed against the claimant's rental unit. This determination may be made in the same manner as used in arms-length transactions according to the methods set forth on the Landlord's Certificate

2) Multiply the amount determined in step one by the amount actually paid by the tenant during the year for the right of occupancy of the property. This figure may be less than the amount of rent actually paid because rent paid must be reduced by any amount included for heat, electricity, furnishings, personal care or other services.

3) Divide the product determined in step two by 85% of the gross rent paid for the right of occupancy as determined by the Federal Department of Housing and Urban Development (HUD) for a similar property in that area pursuant to Section 8(c)(1) of the United States Housing Act of 1937.

4) The resulting quotient is the amount that the claimant may claim as rent constituting property tax under "Allocable Property Tax Method".

The Housing and Urban Development fair market rent figures are used to provide the Department with an easily identifiable and measurable fair market rate broken down by county with a special municipal rate set for the Burlington metropolitan area. The HUD fair market rent calculation is the amount that would be needed to pay the gross rent (shelter rent plus utilities) of privately owned, decent, safe, and sanitary rental housing of a modest (non-luxury) nature with suitable amenities in that area. This rate is calculated yearly by the Federal Department of Housing and Urban Development and is published annually in the Federal Register and is also available on the HUD web site at http://www.huduser.org/datasets/fmr.html. The data from Vermont is also available from the National Low Income Housing Coalition website at http://www.nlihc.org/oor2003/area.php?state%5B%5D=VT

The Department adjusts the HUD figures downward by 15% to reflect the fact that the HUD fair market rent includes the amount needed to pay for utilities while the renter rebate program is based on the rent paid for occupancy of the property and does not include utilities.

Signed: _________________________
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Approved: _________________________
Commissioner of Taxes