



Peat, Marwick, Mitchell & Co.

Certified Public Accountants

One Boston Place
Boston, Massachusetts 02108
617-723-7700

March 29, 1982

Mr. Robert W. Healy, City Manager
City of Cambridge
City Hall
Cambridge, Massachusetts 02139

Dear Mr. Healy:

This letter will confirm our discussion of last week regarding the non-deductibility, for individual federal income tax purposes, of any portion of water and sewer fees paid by residents of the City of Cambridge.

[REDACTED] nevertheless, notwithstanding the fact that water and sewer bills may be based in part on the recovery of interest related to outstanding debt. This situation may be compared to that of a person renting an apartment. Although a portion of rental payments are to pay interest and property taxes incurred by the landlord, the tenant is not entitled to deduct any portion of the rental payment as either interest or property taxes.

As George O'Brien mentioned, there is a Revenue Ruling which has been issued by the Internal Revenue Service (79-201) relating directly to this question. A copy of the ruling is attached for your convenience.

Please call me if you have any questions or need additional information.

Very truly yours,

PEAT, MARWICK, MITCHELL & CO.

Howard F. Crossman, Jr., Partner

HFC:POS
Enc.

cc: Mr. George E. O'Brien, Assistant City Manager,
Fiscal Affairs

26 CFR 1.164-4: Taxes for local benefits.

Taxes; local benefits; utility charges. The portion of a front foot benefit charge assessed against property benefited by construction of a water system and added to the taxpayer's real property tax bill that is properly allocated to interest and maintenance charges is deductible as a tax under section 164 of the Code. No portion of a flat per unit charge or a two-part charge consisting of a metered charge and a uniform charge for maintenance and interest that a sewer or water authority imposes on all its customers is deductible under section 164.

Rev. Rul. 79-201

ISSUE

Is a portion of payments made for water, sewer, and other utility charges deductible under section 164 of the Internal Revenue Code under the situations described below?

FACTS

Situation 1. A city assesses a "front foot benefit charge" against abutting property that is benefited by the construction of a water system. The amount assessed is added to the taxpayer's bill for state, county, and other real property taxes and is designated as a front foot benefit charge. For the current year a taxpayer received a bill that included a front foot benefit charge of 10x dollars, comprised of 8x dollars for the construction of the water system, 1.5x dollars for interest, and .5x dollars for maintenance costs. The 10x dollars was properly allocated to the three purposes.

Situation 2. A city water authority imposes a charge, composed of two parts, on all its customers. The first is a metered charge based on the

amount of water consumed by the customer. The second part is a uniform charge for maintenance interest, computed by dividing the authority's interest and maintenance expense for the year by the number of customers.

Situation 3. A sewer authority imposes a flat charge per unit for each quarter on all residential customers.

LAW AND ANALYSIS

Section 164(a) of the Code provides that certain taxes, including state and local, and foreign, real property taxes, are allowed as a deduction for the taxable year within which they are paid or accrued.

Under federal law, a tax 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 revenue to be used for public or governmental purposes, and not as a payment for some special privilege granted or service rendered. Rev. Rul. 77-201, 1977-1 C.B. 44.

Rev. Rul. 58-141, 1958-1 C.B. 101 states that the question of whether a particular contribution, charge, or burden is to be regarded as a tax depends on its real nature and, if it is not in its nature a tax, it is no material that it may have been so called.

In *Situations 2 and 3*, the charges are not taxes. The charges are merely fees paid for receipt of water and sewer services. See Rev. Rul. 75-346, 1975-2 C.B. 66, and *Mahter v. Commissioner*, 119 F.2d 869, 373 (2d Cir. 1941), cert. denied, 314 U.S. 660 (1941).

In *Situation 1*, the front foot benefit charge is a tax assessed against local benefits of a kind tending to increase the value of the property assessed. It is imposed because of an interest measured by some benefit inuring directly to the property against which the assessment is levied. The property subject to the front foot benefit charge is limited to the property benefited.

Section 164

Section 164(c)(1) of the Code provides that no deduction is allowed for taxes assessed against local benefits of a kind tending to increase the value of the property assessed. However, this rule does not prevent the deduction of so much of such taxes as is properly allocable to maintenance or interest charges.

Sections 1.164-2(g) and 1.164-4(a) of the Income Tax Regulations provide that assessments paid for local benefits such as streets, sidewalks, and other like improvements, are not deductible as taxes. An assessment for local benefits must be imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied. A tax is considered assessed against local benefits when the property subject to the tax is limited to the property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. Deductible real property taxes are those levied for the general public welfare by the proper taxing authority at the same rate against all property in the territory over which the authority has jurisdiction.

Section 1.164-4(b)(1) of the regulations provides that, insofar as assessments against local benefits are made for the purpose of meeting maintenance, repair, or interest charges with respect to such benefits, they are deductible. In such cases, the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation cannot be made, none of the amount so paid is deductible.

Rev. Rul. 75-455, 1975-2 C.B. 68, which concerns front foot benefit charges similar to those described in *Situation 1*, concludes that the charges are taxes assessed against local benefits of a kind tending to increase the value of property assessed, and, as such, the charges are not deductible as taxes under section 164 of the Code, except to the extent that they are properly

allocable to maintenance or interest charges. See Rev. Rul. 76-45, 1976-1 C.B. 51.

In order for maintenance and interest charges to be deductible, there must be a clear delineation or allocation of the items with proper reference to interest and maintenance and repair items. If the customer received no itemized statement, the customer has no basis for claiming a deduction. Rev. Rul. 67-337, 1967-2 C.B. 92, concluded that an allocation of a local benefits assessment to, among other things, "operation and maintenance" was not sufficient. Maintenance in the usual context is the act of maintaining and keeping property in a particular state or condition. Thus, maintenance expenses do not include expenses such as operating expenses, planning expenses, organization and administration expenses, the cost of engineering and legal services, the cost of office equipment, or the cost of billing. Maintenance expenses do include, in the case of a water system for instance, expenses incurred for the repair and maintenance of a purification system, pumping system, or distribution system.

In *Situation 1*, portions of the front foot benefit charge are properly allocated to interest and maintenance charges.

HOLDINGS

Situation 1. The portion of the front foot benefit charge that is properly allocable to interest and maintenance charges, 2x dollars, is deductible by the taxpayer as a tax under section 164 of the Code when paid or accrued.

Situations 2 and 3. No portion of the charges imposed by the water and sewer authorities on their customers is deductible by the customers under section 164 of the Code.

The principles of this Revenue Ruling apply as well to amounts paid to municipalities for other utility services.

WATER

Service Programs	<u>2nd half fiscal 81</u> <u>Jan. - June</u>	<u>1st half fiscal 82</u> <u>July - December</u>	<u>Total</u>
S & W	479 610	499 155	= 978 765
OOM	79 330	121 355	= 200 685
EB	<u>53 000</u>	<u>53 000</u>	= <u>106 000</u>
G Total	611 940	673 510	1 285 450

Fiscal 81	3 420 000	46¢	Fiscal 82	3 778 875	66¢
	1 710 000			1 889 437.5	
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	35.8%			35.6%	

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S & W	126 385	+	174 175	=	300 560
OOM	13 255	+	30 210	=	43 465
MDC	627 210	+	744 860	=	1 372 070
Bonds	161 905	+	596 900	=	758 805
E Benefits	<u>20 000</u>	+	<u>20 000</u>	=	<u>40 000</u>
Grand Total	948 755	+	1 566 145	=	2 514 900

Fiscal 81 2 612 920 31¢ Fiscal 82 2 962 455 46¢



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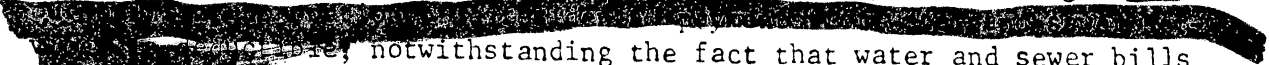
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41, F-97

Comm. from Paul E. Healy, City Clerk, transmitting comm. from Howard F. Crossman of Peat, Marwick, Mitchell & Co. Re: deductibility of a portion of water & sewer charges paid by Cambridge residents on their income taxes.

In City Council,

March 29, 1982