

Four Tips to Avoid Penalties for “Commingling” Residents’ Security Deposits

Owners must be careful about where they keep the money residents give them as security deposits. A security deposit is not in the same category as a rent check or other type of payment an owner may receive from a resident. Technically, the security deposit belongs to the resident. Although you hold it while the resident lives in your building, it is not your money unless and until the resident moves out leaving unpaid rent or damage to the apartment.

New York requires owners to keep security deposits in separate bank accounts and not mix, or “commingle,” them with personal or other business funds [General Obligations Law § 7-103(1)]. “Any commingling of tenant’s security deposits with an owner’s funds—personal, general, or otherwise—is illegal. If there is commingling, I always tell clients that they must clean it up immediately. Nobody wants the attorney general after them,” says attorney Karen Schwartz-Sidrane of the Hewlett, N.Y., law firm of Sidrane & Schwartz-Sidrane, LLP.

In fact, the New York State’s attorney general’s office has its own “Rent Security Complaint Form” that tenants can fill out to initiate an investigation of owners who fail to place security deposits in trust accounts or to pay interest on the security deposits. Along with penalties imposed as a result of an attorney general investigation, courts have ruled that the commingling of a security deposit with an owner’s personal funds entitles a tenant to immediately recover the deposit, preventing the owner from using the security deposit from any damage to the apartment.

Tip #1: Don’t Keep Security Deposits with Personal Funds

While it is okay to keep rent funds in personal bank accounts, it is not okay to treat security deposits the same way. Keeping security deposits with personal funds is considered “commingling.” Failing to keep security deposits in an account separate from per-

sonal funds could therefore undermine your right to keep the deposit and expose you to a lawsuit and damages.

Example: A New York owner kept a resident’s entire security deposit to pay for apartment damage. The owner offered evidence at trial that it incurred the expenses of \$980 to paint two bedrooms, \$75 to repair the kitchen and dining rooms’ light fixtures, and \$175 to remove the resident’s abandoned property. The resident claimed that since the owner deposited the security deposit in his personal bank account, the resident should be allowed to recover the entire deposit. The owner had, in fact, deposited the security deposit and the first month’s rent in his personal checking account and not in a segregated and numbered account as required by New York State law. The court found him guilty of commingling and ordered him to return the security deposit to the resident [Rhodes v. Calhoun, September 2005].

Tip #2: Don’t Mix Security Deposits with Rent and Other Funds

Some owners make the mistake of depositing security deposits in the same account where they keep rent funds. This mistake is easy to make because owners typically receive security deposits and the first month’s rent at the same time. But this is also considered commingling. You must keep security deposits in an account separate from other business funds.

Although you must not commingle security deposits with other business funds, you can keep a resident’s security deposit in the same account with the security deposits of other residents. As long as the account contains only security deposit funds, you will be okay. But if you mix personal or business funds, you will be guilty of commingling. Therefore, you need to make sure you keep careful records showing that you keep only security deposits in the account.

Tip #3: Keep Security Deposit Increases Separated from Personal, Business Funds

Owners are permitted to increase their tenants' security deposits to equal the rent in renewal leases. Generally, the security deposit is equal to one month's rent, so if the rent goes up, the deposit also goes up.

Even if you have been keeping the resident's security deposit in a separate account, it is easy to make a mistake when the resident pays the extra amount to cover the security deposit increase. If you deposit the increase with personal or other business funds, you will be guilty of commingling. Make sure residents give you a separate check for the security deposit increase, and make sure you deposit that check in the same account that you keep the balance of the security deposit. Otherwise, you could be penalized as if you commingled the entire deposit.

Tip #4: Utilize "Tenant Lease Security Accounts" Programs

Security deposits for rent-regulated tenants must be deposited in an interest-bearing account in a New York bank. And owners who deposit security deposits in interest-bearing accounts are entitled annually to 1 percent of the deposit, the "administrative expense" for handling the account. However, calculating interest, keeping track of security deposit increases, and staying on top of the necessary paperwork can be complicated.

"Fortunately, many bigger banks offer customized services for apartment owners to help process their resident's security deposits," says Schwartz-Sidrane. As long as these accounts are utilized properly, participating owners automatically comply with all legal requirements pertaining to keeping tenants' security deposits in trust, as well as all IRS regulations. Here are some of the added benefits these bank programs may offer:

IRS compliance. When you use their Tenant Lease Security Services, the banks usually handle the tax paperwork and meet applicable deadlines. They will manage the tax issues and fulfill IRS reporting requirements, and at year-end, will issue all forms, including 1099s and interest checks, correctly and on time.

Monthly status reports. Owners can either access status reports online or have them sent to the managing agent for each property. The status reports will display the tenants' name, security deposit amount, and amount of interest earned.

Payment of interest. For the payment of interest and mailing of checks, owners can usually choose to have the banks send checks for the tenant's portion of the interest annually, at year-end, or have it held in the account until the tenant moves. All checks and IRS 1099 Forms will be mailed directly to the residents.

Deposits When Buying or Selling Rental Property

Another reason for owners to be diligent about keeping their tenants' security deposits in order is to avoid delays when it comes to the sale of buildings, points out Schwartz-Sidrane. "We are going to see much more buying and selling in the next few years because people can't hold onto their buildings. If a seller can present a report of security accounts, this makes the transaction easier and the buyer can assess where he may have to 'fill in' missing security deposits."

If an owner is selling a building, the general rule is that the owner must transfer all tenant security deposits to the new owner within five days of the sale. After turning the security deposits over, the prior owner must notify the tenants, by registered or certified mail, of the name and address of the new owner. Sellers who fail to turn over tenant security deposits or to notify tenants of a security deposit transfer may be found guilty of a misdemeanor [GOL §7-105].

From a buyer's perspective, if the buyer is buying rent-stabilized apartments, the new owner becomes absolutely responsible for a rent-stabilized tenant's security deposit, whether or not the buyer actually received it from the seller [GOL §7-107]. For rent-controlled apartments or apartments in buildings with six or more unregulated apartments, the buyer is ultimately responsible for those security deposits to which he or she has "actual knowledge."

A buyer in this situation is considered to have actual knowledge of any tenant security deposit that is: (1) deposited in a bank at any time during the six months immediately prior to the sale; (2) acknowledged in any lease in effect at the time of the sale; or (3) supported by "documentary evidence" provided by the tenant [GOL §7-108].

Any potential buyer will do his homework with regard to security deposit issues, so it is in an owner's best interest to keep the security deposits organized and above suspicion.