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ON THE COVER:

A Dapper Tribute—Nearly 30 members of the Real Property Law Section donned bow ties in honor of Peter V. Coffey (front row, fourth from right), who was recognized with the Section's Professionalism Award. The award, which recognizes outstanding competence, legal ability and achievement and civility, was presented during the Section's Annual Meeting luncheon at the 21 Club in New York City on January 29. The group surprised Coffey by wearing bow ties, acknowledging his signature attire.
(Photo by Richard Smith)

Message from the Section Chair

Finally, we are about to enjoy spring. After this winter's cold and snow we all deserve some sunny and warmer weather. Congratulations to those of you who braved our blizzard and arctic weather to attend our Section's Annual Meeting and CLE programs. Leon Sawyko, our Program Chair, did an excellent job organizing the CLE presentations, luncheon and activities and deserves a hearty thank you from all. Special congratulations go to Peter Coffey, our 2015 Professionalism Award recipient. The honor is very well deserved.

I am asking all members of our Section to consider becoming involved with our Committees this year. The RPLS Committees perform the substantive work of our Section, are incubators for new ideas that help our Section members, and present many outstanding CLE programs which benefit our membership. All Section members who are interested in participating in our Committees are welcome to do so. The last pages of our *N.Y. Real Property Law Journal* contain a listing of all Section Committees and Chairs. Please send an email to the Committee Chairs expressing your desire to become a member of their Committee and they will assist you to do so.

We have beta tested our new Real Property Law Section "Community" and we will be rolling out the Community to all Section members this spring. The Community will take the place of our active listserves and will create a long-term searchable knowledge base of subjects that are of interest to our members. The Community will include "Discussions," which are like listservs on topics of interest, a Resource Library, a Searchable Directory of Community members, and Blogs. It will also be used for announcements and have links to RPLS events. Of course, there will be a mobile app, so you can access the Community from your smartphone. Congratulations go to Susan Scharbach and Michael Stevens, our Committee Co-Chairs, and to Committee member Andy Posil and Brandon Vogel, NYSBA's Social Media & Web Content Manager, for launching our Community.

I hope to see many of you at our 2015 Summer Meeting, which will be held at the Basin Harbor Club & Resort on Lake Champlain, at Vergennes, Vermont, from July 16-19, 2015. We are offering a 75% discount of meeting registration fees and hotel accommodations to first-time Real Property Law Section meeting attendees and to attorneys admitted less than 10 years. Mindy Stern will be our Program Chair for the 2015 Summer Meeting and assures us that we have a spectacular venue and wonderful program planned for all at this family and pet-friendly resort. You can register now on our website to assure your place at the meeting.

David L. Berkey

How New York City and State Transfer Taxes Apply to Ground Leases

By Joshua Stein

When a developer finds a suitable development site, the owner of that site often refuses to sell, but instead will only enter into a long-term lease—a "ground lease"—to the developer. With a ground lease the developer can achieve possession and control of the site,[1] almost as if the developer owned it,[2] typically for 99 years, in exchange for paying ground rent.[3] The developer can use a well-written ground lease to obtain financing and develop a substantial project. Ground lease transactions raise far more issues, many of them more interesting, than the issues that arise in an ordinary purchase and sale of a development site. A ground lease often works very well for the owner and, to a lesser degree, the developer. But developers often have to live with that, as part of the cost of doing business.

A ground lease in New York will incur lower transfer taxes than an outright sale at a similar valuation. Lower transfer taxes come at the cost of increased complexity in the issues surrounding those transfer taxes, although that complexity does not in itself justify switching to an outright sale.[4]

As the starting point for discussion, New York City (the "City") and New York State (the "State") both impose a transfer tax on most conveyances of real property. The City and State taxes have many similarities, but also some important differences,[5] particularly as they relate to ground leases.[6]

NY Tax Law Section 1402(a) imposes the State's real estate transfer tax ("NYS RETT") "on each conveyance of real property or interest therein when the consideration exceeds five hundred dollars."[7] An interest in real property includes "a leasehold interest, a beneficial interest…or any other interest with the right to use or occupancy of real property or the right to receive rents, profits or other income derived from real property."[8] This definition seems to capture any ground lease. It is not that simple, though.

The State tax law defines a conveyance as "the transfer or transfers of any interest in real property by any method."[9] Thus, almost any sale, exchange, assignment, [10] or surrender of any lease, even if only an hour remains in its term, attracts NYS RETT. A lease coupled with a purchase option always attracts NYS RETT, regardless of the remaining term of the lease.[11]

Absent an option to purchase, when a landlord and a tenant enter into a long-term lease, such as the typical ground lease, it will not always constitute a conveyance under the State tax law. Instead, the NYS RETT treats a lease without a purchase option as a conveyance only if it meets this three-prong test:

1) the sum of the term…and any options for renewal exceeds forty-nine years,
2) substantial capital improvements are or may be made by or for the benefit of the lessee…, and
3) the lease…is for substantially all of the premises constituting the real property.[12]

The first prong of the test leads some landlords and tenants to limit the term of a ground lease to 49 years precisely to avoid NYS RETT. That seems rather extreme, given the relatively favorable transfer tax treatment of ground leases, as described in this article, and the relatively low rate of the NYS RETT.

The second prong for taxability will be met by almost every ground lease that contemplates a development project.[13]

The third prong raises some odd issues. Regulations issued by the New York State Department of Taxation and Finance ("DTF") define "substantially all of the premises constituting the real property" to mean "ninety percent (90%) or more of the total rentable space of the premises, exclusive of common areas."[14] DTF regulations then define "premises" to mean, in relevant part: "where a lease…is of vacant land, any portion of such vacant land."[15] In other words, if a property owner owns a single large vacant lot and leases only a small corner of that land to a developer for 50 years, that corner will be deemed "substantially all of the premises constituting the real property."[16] That result seems somewhat counterintuitive, especially if one starts from and believes the words of the statute. Intuition is, however, rarely a good guide to New York real estate transfer taxes. If intuition were a good guide, one would intuitively not expect leases demising less than "substantially all of the premises" to qualify for any special treatment at all in the first place.[17]

For any taxable conveyance, the NYS RETT will equal "two dollars ($2) for each five hundred dollars ($500) of consideration or fractional part thereof."[18] In other words, the NYS RETT is 40 basis points, rounded up to the next even number of whole dollars.

In general, consideration means "the price actually paid or required to be paid for the real property or interest therein, including payment for an option or contract to purchase real property."[19] For creation of a leasehold interest, State tax law provides:

> consideration shall include but not be limited to the value of the rental and other payments attributable to the use and occupancy of the real property or interest therein, the value of any amount paid for an option to purchase or renew and the value of rental or other payments attributable to the exercise of any option to renew.[20]

For a taxable ground lease, consideration includes any payment the tenant makes to obtain the ground lease (so-called "key money") and the present value of the right to receive rental payments or other payments for use and occupancy,[21] for the base term and any possible renewal term.[22] In other words, State tax law assumes the tenant will exercise all renewal options. That assumption seems reasonable.[23]

To calculate the present value of the incoming rental stream,[24] the taxpayer[25] (the landlord) must, at least as a starting point, use "a discount rate equal to 110 percent of the federal long-term rate, compounded semiannually."[26] This article calls that the "default discount rate." Given today's interest rates, the default discount rate is less than 4%, very low, likely to produce unrealistically high taxable consideration for any long-term ground lease.

The DTF regulations do, however, acknowledge that using the default discount rate may produce taxable "consideration" in excess of the leased property's fair market value as if sold.[27] If the taxpayer establishes that this is so, then DTF allows the taxpayer to use a higher discount rate, to derive consideration for the lease that more accurately reflects the fair market value of the property as if sold.[28] This example, based on a DTF regulation, will help explain.[29]

Assume A, as landlord, creates a lease with B as tenant. The lease is for a term of 60 years and covers an entire plot of undeveloped land A owns. The lease allows B to make substantial capital improvements to the land. A will receive $6,000,000 in rent over the lease term. The applicable federal long-term rate for December 2014 is 2.72% compounded semi-annually. The default discount rate used to calculate present value equals 2.99% (i.e., 2.72% multiplied by 110%). That brings the present value of the rent to $1,623,500.

Because all three conditions in Section 1401(e) are met, creation of the lease constitutes a conveyance subject to NYS RETT. The taxable consideration is the present value of the rent based on the default discount rate—i.e., $1,623,500.[30] Therefore, the landlord owes NYS RETT, at a rate of $2 for each $500 (or part thereof) of consideration, in the amount of $6,494 ($1,623,500 divided by 500 is $3,247).

If the taxpayer can show that $1,623,500 does not reasonably approximate the leased property's fair market value, as if sold, the taxpayer may use a discount rate that would produce consideration equal to that fair market value. For example, suppose A has recently received many offers to purchase for only $1,000,000. A may then use a discount rate of 4.99%, instead of the default discount rate, in calculating the taxable consideration. The taxable consideration would then equal about $1,000,000 as opposed to $1,623,500. A would ultimately save $2,494 (nearly 40%) in NYS RETT, perhaps exceeding the legal fees required to reach this favorable result.

Turning from the NYS RETT to the New York City real property transfer tax ("NYC RPTT"), one encounters a pleasant surprise, an exception to the common assumption that the City's taxes are more burdensome than the State's. The analysis begins with New York City Administrative Code ("Admin Code") Section 11-2102: "A tax is hereby imposed on each deed at the time of delivery by grantor to grantee when the consideration for the real property and any improvements thereon (whether or not included in the same deed) exceed twenty-five thousand dollars."[31] Section 11-2101 defines several terms, including "deed," "real property," and "consideration." The City's definitions of these terms generally match the State's, except as this article notes.[32] As one very important difference, the NYC RPTT applies to the creation of any lease, regardless of term.[33] This avoids some philosophical nuances discussed earlier. But it means any "consideration" at all for any lease in the City will attract a tax.

Section 11-2102(a)(10) sets the NYC RPTT rates for "a grant, assignment, or surrender of a leasehold interest in real property."[34] A typical ground lease falls in the category taxed "at the rate of 1.425% of the consideration…where the consideration is $500,000 or less, and at the rate of 2.625% of the consideration where the consideration…is more than $500,000."[35] Thus in New York City the tax rate on a ground lease is typically 2.625%—more than six times the State's tax rate.

Although City transfer tax rates are high, the NYC RPTT excludes from taxable "consideration" for a ground lease any payment that constitutes "rent" for purposes of the City's commercial rent or occupancy tax (the "CRT").[36] This exclusion is unique to the City, because CRT is unique to the City.

The City imposes CRT on "rent" paid to occupy or use certain premises in the City "for carrying on or exercising any trade, business, profession, vocation, or commercial activity including any premises so used even though it is used solely for the purpose of renting, or granting the right to occupy or use, the same premises in whole or in part to tenants."[37] In other words, CRT is a tax on commercial tenants, including ground lease tenants – anyone who conducts any form of business in leased premises.

The CRT defines "rent" as:

> The consideration paid or required to be paid by a tenant for the use or occupancy of premises, valued in money, whether received in money or otherwise, including all credits and property or services of any kind and including any payment required to be made by a tenant on behalf of his or her landlord for real estate taxes, water rents or charges, sewer rents or any other expenses (including insurance) normally payable by a landlord who owns the realty other than expenses for the improvement, repair or maintenance of the tenant's premises.[38]

A "tenant" means: "[a] person paying or required to pay rent for premises as lessee, sublessee, licensee or concessionaire."[39] A ground tenant thus constitutes a "tenant" who pays "rent" within the meaning of the CRT.

For NYC RPTT purposes, Admin Code Section 11-2102(a)(10)(iii) states generically that "the amount subject to tax…shall be only such amount as is not considered rent for purposes of [CRT]."[40] This exclusion makes a huge difference. It means that, under City tax law, the only consideration paid for the grant of a ground lease consists of whatever "key money" or other consideration the tenant pays to obtain the lease. The rent itself is not taxable consideration, as it would be under State tax law.

One might think the "rent" exclusion would apply only to leases that are actually subject to CRT, but the Admin Code does not suggest that reading. City tax officials have not interpreted the "rent" exclusion that way, either. The NYC RPTT's exclusion of "rent" from "consideration" seems to apply whether or not the ground tenant actually owes CRT on that rent, after taking into account the CRT's limits and scope. Some of those limits are geographic. Others impose threshold values on untaxed rent.

Taxpayers should proceed with care, though. Little written authority beyond the Admin Code itself supports this favorable definition of "consideration." The Admin Code simply excludes "rent" as defined in the CRT. At one point, the City issued a tax ruling that can, with close scrutiny, be interpreted to support the favorable reading the City has historically applied to ground rent. In that ruling, City tax officials passed up an opportunity to limit the "rent exclusion" so it applies only to leases actually subject to CRT.[41] The author has found no other City tax ruling to confirm that analysis. According to industry lore, though, the City has consistently disregarded any "rent" (as defined in the CRT) in calculating NYC RPTT anywhere in the City. Even if a ground lease attracts no NYC RPTT—because it requires only payment of "rent" and no other consideration—the parties still need to file a NYC RPTT tax return. For the privilege of doing that, the City charges a fee.

Regardless of the measure of the NYS RETT and the NYC RPTT, the parties to a ground lease also need to think about when the obligation to pay either transfer tax actually arises. Transfer tax does not attach to every ground lease when the parties sign it. Occasionally, the parties will sign a ground lease and it will never attract any transfer tax.

The parties to a ground lease sometimes negotiate a due diligence period, which starts from signing of documents and gives the tenant an option (e.g., for 90 days or six months) to proceed, usually without paying an option fee.[42] A tenant can use that period to finish its homework on the transaction. With comfort that the due diligence period (free option) gives it site control, the tenant can safely invest more money in evaluating the development project. The lease term would not begin and the landlord would not deliver possession of the leased premises until the due diligence period expires. If the tenant likes what it learns in due diligence, the tenant goes ahead with the transaction by giving a notice to proceed. If the tenant doesn't like what it learns, the transaction ends and the tenant never takes possession. As a practical matter, due diligence periods also give prospective tenants an opportunity to find debt and equity financing sufficient to close the transaction and proceed with development—perhaps the most important piece of information a developer needs to learn in the due diligence period for any development project.

Instead of entering into a lease that doesn't become effective until the tenant decides to proceed, landlord and tenant might enter into an "agreement to lease" with an expiration date by which the "agreement to lease" will become a lease (or not). If the tenant decides to proceed, then the parties would sign a lease, equivalent to delivering a deed at a purchase and sale closing. Until the tenant's option period ("due diligence" period) expires, and the parties sign a lease, the tenant can complete its due diligence and decide whether to proceed.

Whether the parties sign a lease subject to a possible future "notice to proceed" or an agreement to lease with a possible lease closing later,[43] conveyance would not occur, consideration would not be deemed delivered, and transfer tax would not attach until the landlord actually delivers possession. Until that time, a taxable event will not have occurred.[44]

The taxable event in either of these structures turns on the definition of "interest" in real property, which appears in NY Tax Law Section 1401(f), particularly the statutory reference to transactions "with the right to use or occupancy of real property."[45] The exemptions to taxable conveyances listed in NY Tax Law

Section 1405(b) state: "The tax shall not apply to the following conveyances:…(9) Conveyances of real property…without the use or occupancy of such property or the granting of an option to purchase real property without the use or occupancy of such property."[46]

In an advisory opinion issued to Waldbaum, Inc. (the "Waldbaum Advisory Opinion"), DTF opined that interim lease periods during which a tenant conducts due diligence investigations, but does not pay rent or occupy the premises, do not count as part of the lease term or trigger RETT. DTF concluded that "the interim term of the ground lease can be characterized, pursuant to section 1405(a)(9) of the [State] Tax Law, as a contract to sell real property without the granting of the use or occupancy of such property."[47]

DTF further opined:

> The fact that Petitioner has access to the property during the interim term, in order to conduct engineering and feasibility studies for the purpose of securing building permits and approvals, does not rise to the level of having the "use or occupancy" of the property [sufficient to constitute an interest in real property under Section 1401].[48]

In sum, if the parties sign a lease that unambiguously limits the tenant's allowable use of the property (so the tenant can do nothing more than conduct due diligence) in the due diligence period, then that lease is not in and of itself (yet) a conveyance of an interest in real property. Therefore, it does not (yet) trigger the NYS RETT.

If the signing of a lease with a due diligence period does not start the lease term or trigger NYS RETT, then at what moment in time will such a lease attract NYS RETT? Generally, in these transactions the lease term will begin at the end of the due diligence period, once all commencement contingencies are met. Often the tenant will need to give formal notice to proceed, effectively an option exercise notice. Whatever the lease requires for the tenant to take possession, once that happens the landlord owes NYS RETT.

In the Waldbaum Advisory Opinion, the lease term began (i.e., the tenant obtained use and occupancy of the property)—and the landlord owed NYS RETT—as soon as the tenant obtained all the approvals it needed to start its initial improvements on the premises.[49]

If a lease provides for a due diligence period, but allows the tenant to start preliminary work on site, that may give the tenant enough "use and occupancy" to start the lease term and trigger NYS RETT.[50] It matters, though, who does the work. If the lease requires the landlord to do preliminary work, the lease term would still begin only when the tenant takes possession.[51] According to DTF, "if Tenant is responsible for…construction…the lease term would begin with the Tenant's use or occupancy upon the commencement of the Construction Period."[52]

If a ground lease allows the ground tenant to receive rent from subtenants in the due diligence period, it could well be taxable from inception. The right to receive that rent could constitute constructive leasehold possession by the ground tenant.

To summarize all of this, the NYS RETT applies to "consideration" given in exchange for the "conveyance" of a leasehold under a ground lease (an "interest in real property") in the State, if the lease meets certain requirements. Consideration for the NYS RETT includes any payments made to obtain the lease. It also includes the present value of future rent payments discounted at 110% of the applicable federal long-term rate compounded semi-annually. If the taxpayer can show the default discount rate produces consideration beyond the property's fair market value as if sold, the taxpayer can use a higher discount rate.

The City imposes NYC RPTT on each "deed" (including creation of any lease) when "consideration" exceeds $25,000.[53] But consideration excludes payments constituting "rent" for CRT purposes, even if no one owes CRT on that "rent." Because ground lease payments typically qualify as "rent," they do not attract NYC RPTT.

If a lease contemplates a due diligence period, the parties can defer transfer tax until the landlord delivers possession, but the lease must limit the tenant's possessory rights in the meantime.

The transfer taxes on creation of a ground lease in the City are relatively low when compared with the usual transfer tax burden on City real estate transactions. Even if a ground lease triggers a NYS RETT, which it usually will, that tax will remain relatively low—sort of like the transfer taxes that apply to real estate transactions almost anywhere else in the United States. The NYS RETT on a ground lease hardly gives the parties a reason to limit the term of a ground lease just to avoid tax.

Endnotes

1. The archetypal transaction involves vacant land. Sometimes the leased premises consist of land plus an existing building, which the developer will redevelop or demolish and replace with a new structure. Sometimes a "ground lease" will even refer to a long-term lease of part of a building, if it has the basic attributes of a ground lease: a very long term with flexibility almost equivalent to ownership, and creating an "investment"-type asset rather than a mere "occupancy" arrangement. Others, including Black's Law Dictionary and prominent members of the New York City real estate bar, believe a lease cannot be a "ground lease" unless it includes some ground.
2. The landlord will want comfort that the developer will: (a) complete and pay for a reasonable development project; (b) operate the project in a reasonable and responsible way; and (c) at the end of the lease term, return a building in reasonable condition. The more

comfort—and the more detail—the landlord seeks on these issues, the more difficult the ground lease negotiations will be.

3. Determination and future adjustment of that rent over many decades becomes crucially important, of course. *See, e.g.*, Joshua Stein, "The Most Important Issue in Every Ground Lease," New York Real Property Law Journal, Winter 2014, at 17.

4. The transfer tax issues in a ground lease are not nearly as interesting as the issues that arise within the ground lease itself, though.

5. Many regard the City tax as more burdensome than the State's. That is often a good rule of thumb. The City tax certainly has a higher rate. But, even before considering the differences flagged in this article, the City tax is not always more burdensome. For example, the State taxes a transfer to or from a charitable organization, whereas the City sometimes does not.

6. The principles discussed here generally also apply to subleases, but this article does not consider subleases. Also, the various transfer taxes have numerous inconsistent exceptions and counterintuitive traps, and a few opportunities, any of which can potentially apply to ground lease transactions. This article disregards those generic matters. It also does not consider real estate transfer taxes imposed in a few municipalities other than New York City. Those taxes look very much like the State transfer tax, but one cannot assume they always match. One should instead research any municipal tax that might apply. The State transfer tax exempts leases to certain new businesses that participate in the START-UP NY program under NY Econ. Dev't Law Article 21; *see* N.Y. Tax Law § 1405(b)(11) (McKinney 2013). This exemption is one of many examples in which New York promotes economic development by exempting favored businesses from the burdens that apply to everyone else, rather than lessening those burdens for all. This in turn maximizes the importance of government agencies and officials and often requires any developer to seek help in navigating the paperwork and procedures.

7. NY Tax Law § 1402 (McKinney 2014).

8. NY Tax Law § 1401(f) (McKinney 2014).

9. NY Tax Law § 1401(e) (McKinney 2014).

10. A collateral assignment is not a conveyance within the meaning of Section 1401 and does not attract transfer tax. *See* N.Y. St. Dept. of Taxation & Fin. Advisory Op. No. TSB-A-97(4)R. It may, however, attract a mortgage recording tax under some circumstances.

11. 20 NYCRR § 575.7(c)(1) ("An option to purchase real property is an interest in real property. Where an option to purchase real property is coupled with the granting of the right to use and occupancy of the real property, a conveyance subject to the transfer tax has occurred."). Ground lessors generally try to avoid granting purchase options. In most cases, a ground lessor enters into a ground lease precisely because the ground lessor does not want to sell. The ground lessor assumes any purchase option will be exercised at the earliest possible opportunity, usually a good guess. Most ground lessees unhappily live without purchase options.

12. NY Tax Law § 1401(e) (paragraph breaks added).

13. The State tax law offers no guidance on when capital improvements will be substantial enough to satisfy the second prong of the test in NY Tax Law § 1401(e).

14. 20 NYCRR § 575.7(a)(3).

15. 20 NYCRR § 575.7(a)(3)(iii).

16. 20 NYCRR § 575.7(a)(1-3).

17. In N.Y. St. Dept. of Taxation & Fin. Advisory Op. No. TSB-A-07(2)R, DTF interpreted the term "substantially all of the premises," in the context of a long-term lease demising part of an existing shopping center. In determining that such a lease is not for substantially all of the premises and thus not subject to transfer tax, DTF applied a broad definition of premises. DTF stated that "it is important to view the matter with an eye on the unique nature of the shopping center enterprise from a business and legal perspective and look beyond the examples given in [Section 575.7(a)(3)]." DTF cited an earlier advisory opinion, Adv Op Comm T&F, September 27, 2005, Harter, Secrest & Emery, LLP, 604-2711, Adv Op Comm TSB-A-05(1)R, 2005 (the "Harter Secrest Advisory Opinion") and then observed: "because a shopping center is operated by the landlord and tenants as a closely integrated retail enterprise, the relevant premises must include all of the real property constituting the shopping center." Concluding that because the lease affected "less than 90% of the total rentable space available to all tenants in the entire shopping center, exclusive of common areas," DTF said the transaction does not incur NYS RETT. In contrast, an equivalent lease of vacant land elsewhere in the same tax lot might be deemed "substantially all of the premises," as noted above. Any logical or "tax policy" reason for that distinction is not readily apparent.

18. NY Tax Law § 1402(a) (McKinney 2014).

19. NY Tax Law § 1401(d) (McKinney 2014).

20. *Id*. If the tenant agrees to build a building on the site, would that building, or the promise to build it, constitute "consideration" for the ground lease? Historically it never has. To treat the building as "consideration," one would first need to predict the value of the building at the end of the lease term, then discount it back to present value. If the assumed discount rate even slightly exceeds the assumed appreciation rate, the present value will approach zero. Even if one can reasonably predict those rates, how can one predict the likely condition or value of the building at the end or premature termination of the lease? One should often assume the building will, at the end of the lease term, be obsolete and in need of major capital expenditures, the result of deferred maintenance in the last decade or so of the lease term. What value will such a building have? And if the "promise to build" constitutes consideration, what about the "promise to insure" and the "promise to maintain" and the "promise to pay taxes" and all the other promises in the lease? Don't all those benefit the landlord somehow? Shouldn't all these other promises also constitute consideration? Instead, it probably makes more sense to treat the "promise to build" as part of the internal workings of the lease—part of the reason the transaction makes sense, sort of like a very large security deposit—rather than consideration for the lease. That doesn't mean DTF won't try to tax the "promise to build" as part of the response to some future budget crisis. On the other hand, in 2005, DTF did issue the quite extensive Harter Secrest Advisory Opinion on taxation of ground leases. That opinion explored a variety of hypothetical cases, including some where the tenant would construct substantial capital improvements. Nothing in that advisory opinion suggested at any point that "consideration" running to the landlord might include the tenant's promise to build. On the other hand, if the tenant induced the landlord to sign a ground lease by immediately conveying to the landlord some existing building somewhere else, then the value of that building would presumably constitute consideration, the transfer of which would attract at least one transfer tax and very likely two.

21. *See* 20 NYCRR § 575.7 (b)(2)(ii) (2014). Actually the NYS RETT considers only the landlord's "net rents," meaning gross rents less estimated operating costs the landlord pays. "Such operating costs include amounts paid for heat and gas, electricity, furnishings, insurance, maintenance, management and real estate taxes[.]" A ground lease will, however, almost always pass all those costs through to the tenant, eliminating any savings opportunity. And if the landlord offered to pay those costs to reduce tax, the rent would rise accordingly, defeating the purpose.

22. *See* 20 NYCRR § 575.7(b)(1). Both for the threshold determination of taxability and for calculating the tax, the statute assumes the tenant will exercise all renewal options, treating them as part of the lease term. That sometimes comes as a surprise to smart and creative real estate people. They often think, but only briefly, that they can outwit the tax by having a short initial term followed by many renewal options.

23. In a properly negotiated and typical development ground lease for vacant land, the rent should reflect just the value of the vacant land. Once the tenant has built a building on that land, the burden of paying rent should always fall far below the benefit of continuing to effectively "own" the building and having a place to put it. So the tenant should always want to continue the lease as long as possible, implying the tenant should exercise all renewal options (unless, of course, for some reason they have become uneconomic). To avoid issues about forgetting to exercise extension options, it will usually make sense to eliminate them and just extend the lease term, perhaps with termination options along the way. If no credit (and no collateral beyond the building) backs the tenant's leasehold obligations, then the tenant in effect has a termination option at all times.

24. If the actual rental payments are "tied to unknown factors," DTF regulations require the taxpayer to make "a reasonable estimate" of how those payments will turn out. 20 NYCRR § 575.7(b)(3). This would presumably cover CPI adjustments, land value rent resets, and the like, which often appear in ground leases. The taxpayer may need a crystal ball. But it's not too different from the crystal ball used by any ground lease appraiser.

25. *See* N.Y. Tax Law § 1404(a). The law requires a landlord, as the transferor, to pay NYS RETT. If the landlord (transferor) fails to pay, or is exempt, the tenant (transferee) must pay. If the landlord must pay it, but the tenant agrees to do so instead, then that payment constitutes additional consideration, itself taxable under the NYC RPTT and NYS RETT. If the tenant pays that second iteration of tax, however, that payment does not attract a third iteration of tax. In a substantial outright sale, the parties can actually save a few pennies by having the purchaser pay the seller's transfer tax and repricing the deal accordingly. Do the math. That small tax-saving opportunity doesn't work for ground leases, though, because of how the NYC RPTT works, as described later in this article.

26. 20 NYCRR § 575.7(b)(2). The calculation will use the rate in effect 30 days before the date of transfer. The federal long-term rate is announced every month, *available at* http://apps.irs.gov/app/picklist/list/federalRates.html (last visited December 25, 2014).

27. 20 NYCRR § 575.7(b)(2)(ii).

28. *See* 20 NYCRR § 575.7(b)(2). The regulations do not say how the taxpayer would go about "establish[ing]" that the "consideration" exceeds fair market value. Presumably, current appraisals from reputable appraisers would be the gold standard. If the taxpayer has received offers to purchase, those would help. Presumably whatever the taxpayer offers, if anything, DTF will respond by asking for more. It will become a typical valuation dispute, of the type well known in tax and other law. The taxpayer should plan for that possibility.

29. The example comes from 20 NYCRR § 575.7(b)(5) example 1 (2014), after filtering out a "red herring" discussion about the landlord's paying some operating costs.

30. This assumes the tenant pays no up-front "key money" or other inducement payment.

31. New York, N.Y., Admin Code § 11-2102(a) (West, Westlaw through L. 2013, ch. 517 and Local Law 113 of 2013).

32. New York, N.Y., Admin Code § 11-2101.2, 5, & 9 (West, Westlaw through L. 2013, ch. 517 and Local Law 113 of 2013).

33. New York, N.Y., Admin Code § 11-2101.2 (defining "deed"); § 11-2102(a)(10) (West, Westlaw through L. 2013, ch. 517 and Local Law 113 of 2013).

34. New York, N.Y., Admin Code § 11-2102(a)(10) (West, Westlaw through L. 2013, ch. 517 and Local Law 113 of 2013).

35. New York, N.Y., Admin Code § 11-2102(a)(10)(ii) (West, Westlaw through L. 2013, ch. 517 and Local Law 113 of 2013).

36. *See Id.* The net rate of CRT equals about 4% of rent paid by substantial commercial tenants in Manhattan south of 96th Street, subject to many exemptions and exclusions irrelevant to the present discussion. Almost no other jurisdiction in the United States imposes such a tax. CRT payors also typically pay, among other taxes and charges, the following extraordinary collection of City and State taxes, generally mitigated by their deductibility (a) City income tax of up to almost 4%; (b) City general corporation or unincorporated business tax of up to 8.85%, in some cases credited against "a" or vice versa; (c) through their rent, a contribution to City property taxes, often around $10 a square foot, at least in prime areas of Manhattan; (d) sales tax of 8.875% on purchases of goods and services except for resale; (e) a metropolitan commuter transportation mobility tax of 0.34%; (f) taxes on electricity and telecommunications (including a significant chunk of the total bill for any cellphone number with a New York mailing address); (g) separate charges for water, sewer and commercial garbage collection (taxes don't cover them); (h) directly or indirectly, the cost of sidewalk sweeping, snow removal, maintenance, repair and often reconstruction (taxes don't cover them either); and (i) State income taxes at some of the highest rates in the nation.

37. New York, N.Y., Admin Code § 11-701.5 (West, Westlaw through L. 2013, ch. 517 and Local Law 113 of 2013).

38. New York, N.Y., Admin Code § 11-701.6 (West, Westlaw through L. 2013, ch. 517 and Local Law 113 of 2013).

39. New York, N.Y., Admin Code § 11-701.3 (West, Westlaw through L. 2013, ch. 517 and Local Law 113 of 2013).

40. New York, N.Y., Admin Code § 11-2102(a)(10)(iii) (West, Westlaw through L. 2013, ch. 517 and Local Law 113 of 2013).

41. N.Y.C. Dep't Fin. Ltr. Rul., FLR 96-4666 (Feb. 24, 1997), 1997 WL 168624. In relevant part, a taxpayer deeded property to the New York City Industrial Development Agency and leased it back under a "Prime Lease." The City concluded that no RPTT was due on that rent, as the Prime Lease was a "true lease" under which the tenant will "pay rent for the use and occupancy" of the premises. The City quoted Admin Code § 11-2101.1 and § 11-2101.2, with their blanket exclusion from RPTT of any amount constituting rent under the CRT; hence the parties owed no RPTT on the rent under the Prime Lease. The ruling nowhere suggested that the blanket exclusion of "rent" under the CRT applies only in areas of the City subject to CRT. To the contrary, the ruling said nothing at all about the location of the leased premises. This suggests location is irrelevant, hence whether the property is located in an area subject to CRT is irrelevant. In other words, the City seems to suggest the same principles apply anywhere in the City. It is a suggestion inferred from silence. It thus lacks the clarity and certainty a taxpayer might prefer. Taxpayers should note that, while it may not attract RPTT, a sale and leaseback transaction may be considered a financing arrangement subject to the State's mortgage recording tax.

42. The tenant may agree to pay carrying costs during the due diligence period. If the tenant also receives the benefit of rental income in that time, that may interfere with the favorable treatment of due diligence periods as described in the next few paragraphs of this article.

43. The parties may have psychological reasons to resist a two-step process, even if it leads to the exact same sequence of possible events, i.e., one party or

the other may feel better knowing that something called a "lease" is in place rather than something that feels more like an option.

44. *See* Harter, Secrest & Emery, LLP, N.Y. Dep't Tax & Fin. Tech. Servs. Div. Adv. Op., TSB-A-05(1) R (Sept. 27, 2005), 2005 N.Y. Tax LEXIS 231. Scenario 5 discussed in that opinion suggests that any payments in the due diligence period would not constitute taxable rent under NYS RETT. *Id.*
45. NY Tax Law § 1401(f) (McKinney 2014).
46. NY Tax Law § 1405(b)(9) (McKinney 2014).
47. Waldbaum, Inc., N.Y. Dep't Tax & Fin. Tech. Servs. Bur. Adv. Op., TSB-A-99(1) R (Mar. 1, 1999), 1999 N.Y. Tax LEXIS 68.
48. *Id.*
49. *See id.*
50. *Id.*
51. *See* Harter, Secrest & Emery, LLP, N.Y. Dep't Tax & Fin. Tech. Servs. Div. Adv. Op., TSB-A-05(1) R (Sept. 27, 2005), 2005 N.Y. Tax LEXIS 231.
52. *See id.*
53. New York, N.Y., Admin Code § 11-2102 (West, Westlaw through L. 2013, ch. 517 and Local Law 113 of 2013).

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A Primer on New York's Mortgage Recording Tax

By Michael J. Berey

This article explains New York State's mortgage recording tax in a manner intended to afford any attorney handling a real estate transaction with a basic understanding of this complex subject. Mortgage tax, a tax on the "privilege" of recording a mortgage in New York,[1] is imposed under the authority of Article 11 ("Tax on Mortgages") of the State's Tax Law.

Mortgage tax rates vary depending on where the mortgage is to be recorded. They range from $.75 for each $100 of principal amount secured or major fraction thereof[2] in certain upstate counties, to $2.80 for each $100 of principal amount secured or major fraction thereof for a mortgage of $500,000 or more on commercial real property in The City of New York.[3] Accordingly, recording a mortgage in New York State can be expensive. For example, the mortgage tax payable to record a $100,000,000 mortgage on commercial real property in New York City is $2,800,000. The tax payable to record a $400,000 mortgage on a one-to-three family dwelling ranges from $3,000 and $8,200, less a small credit against part of the Additional Tax, discussed below, depending on the location of the property.

The mortgage tax provides government with a significant amount of revenue. During the State of New York's fiscal year 2013-2014 (April 1, 2013–March 31, 2014), mortgage recording tax collected statewide was $1,765,071,336, with $1,216,719,377 being collected on mortgages recorded in New York City.[4]

New York City

In New York City, the applicable rate for mortgage tax varies depending on the type of real property and the amount secured. All mortgages securing less than $500,000 are taxed at the rate of $2.05 for each $100 of the principal obligation secured. A mortgage on a one-to-three family dwelling, or on an individual residential condominium unit, securing $500,000 or more is taxed at the rate of $2.175 for each $100 of the principal obligation secured. The so-called commercial rate of $2.80 for each $100 of principal secured applies when a mortgage secures $500,000 or more and is a lien on other than a 1-3 family residence or an individual residential condominium unit. A mortgage on more than one uncombined condominium units is subject to the $2.80 rate.

The State's Department of Taxation and Finance (the "Department") issued an Advisory Opinion dated July 2, 2014[5] on the application of mortgage tax to a purchase money mortgage securing more than $500,000 encumbering three separate but adjacent units intended to be combined by the mortgagor into a single apartment. According to the Department, the applicable rate is $2.175. However, the Advisory Opinion indicates that if the units are not, in fact, later combined, further tax will be owed, computed on the spread between the rates of $2.175 and $2.80, presumably with interest and penalties applied due to the underpayment of tax.

State law authorizes New York City's local legislative body to adopt a local law imposing mortgage tax on a lien on an individual cooperative apartment located within the City, but this has not been done.[6]

The principal amounts secured by mortgages on real property in New York City may be aggregated to reach $500,000 to apply the higher, commercial rate. There is a presumption that all mortgages, executed by the same or related persons and recorded against real property anywhere in the City within a 12-month period, are part of a related transaction and, as such, they may be treated as a single mortgage for the purpose of determining the applicable rate of tax on each of the mortgages.[7]

In practice, when a mortgage of record less than one year is to be satisfied and a new mortgage is to be recorded, which is more likely with residential real property, an affidavit may be submitted with the mortgage being recorded affirming that the existing mortgage has been paid off and will be satisfied of record, requesting that aggregation not apply.

Elements of Mortgage Tax

Mortgage tax includes a Basic Tax of $.50 for each $100 of principal obligation secured[8] [Tax Law Section 253], a Special Additional Tax of $.25 for each $100 of principal obligation secured [Tax Law Section 253-1a],[9] both of which apply in all counties, and, in a number of counties, an Additional Tax of $.25 or, in counties within the Metropolitan Commuter Transportation District, $.30 for each $100 of principal obligation secured [Tax Law Section 253-2a].[10] Local mortgage taxes are also charged on recording a mortgage in New York City and in other counties. In Westchester and Rockland, for example, adding the local tax, the rate is $1.30 for each $100 of principal obligation secured, except for mortgages on real property in the City of Yonkers where the tax is $1.80.

Tax Law Section 253-1a requires that the Special Additional Tax be paid by the lender when the mortgaged property is principally improved, or is to be improved by a 1-6 family dwelling with separate cooking facilities, or when the mortgagor is a not-for-profit organization no part of the net earnings of which ensure to the benefit of any officer, director or member and which is exempt from taxation under IRC Section 501.[11] This can be an issue at closing if the lender is unwilling to pay the tax.

There is case law holding that the Special Additional Tax need not be paid by a federally chartered savings association, including federal savings banks,[12] and the Department continues to take the position, notwithstanding a decision in 2010 by the Supreme Court, New York County,[13] that the Special Additional Tax is not payable on a mortgage given to a federal credit union on real property principally improved or to be improved by one or more structures containing in the aggregate not more than six residential dwelling units, each having its own separate cooking facilities.[14] The Special Additional Tax is not payable at on a mortgage on such a property made to a New York State chartered credit union organized under the Banking Law.[15]

Under Tax Law Section 253, when the mortgagee is a natural person, a mortgage on real property with six or less residential dwelling units each with separate cooking facilities, is exempt from payment of the Special Additional Tax.[16]

An affidavit must be submitted to the recording officer claiming an exemption.

For the Additional Tax, if a mortgage recites that the real property is improved or will be improved by a one-or-two family house or a residential dwelling unit, there is an exemption of up to $25 or $30, depending on the applicable rate of Additional Tax.[17]

Multiple Counties

If a mortgage encumbers real property in multiple counties, under Tax Law Section 260, mortgage tax is apportioned based on the relative tax assessed values of the mortgaged properties. In practice, tax computed using Department Form MT-15[18] is paid to the recording officer of the county in which the mortgage is first recorded. A certified copy of the mortgage as first recorded will then be recorded in the other counties affected by the mortgage, accompanied by an explanatory affidavit. The Department will divide the tax paid among the jurisdictions involved.

Alternatively, the mortgage can be recorded in, and the full tax paid without allocation, to the recording officer of a county with the highest tax rate amongst the counties in which the mortgage is to be recorded, the other mortgages being recorded elsewhere as additional collateral security for the same indebtedness, accompanied by an affidavit claiming exemption on the grounds that the tax on the full amount of the mortgage was already paid. Since tax is being paid at the highest applicable rate on the entire obligation secured, this may cause a greater amount of tax to be paid than if there was an allocation using Form MT-15.

Also, under Tax Law Section 260, when a mortgage encumbers real property inside and outside of New York State, the tax is computed on the portion of the principal indebtedness which is computed by calculating the proportional value of the net value of the mortgaged property within New York State over the net value of all of the property mortgaged. The mortgage can only be enforced in New York to the extent of the tax paid.

Underpayment of Tax

A mortgage cannot be received in evidence in any action or proceeding, and cannot be released, discharged, assigned or modified or recorded if the proper amount of tax is not paid.[19] If it is determined that mortgage tax is due, the Department may direct the county recording office to record a notice of a mortgage tax deficiency. Until the proper amount of tax, and any interest and penalty charged is paid, and any such notice is released of record, the recording office will not record any instrument relating to the mortgage.

A mortgage cannot be foreclosed unless the proper amount of mortgage tax is paid. Even if the mortgage has not been recorded, case law, applying Tax Law Section 258, holds that the note cannot otherwise be enforced until mortgage tax has been paid.[20] Tax Law Section 258 states that "[n]o judgment or final order in any action or proceeding shall be made for the foreclosure or the enforcement of any mortgage which is subject to any tax imposed by this article or of any debt or obligation secured by any such mortgage, unless the taxes imposed by this article shall have been paid…."[21]

Interest and penalties are significant. For mortgages on real property located with New York City, for example, the interest rate for late payments and assessments of tax is set quarterly. For the period January 1, 2015 to March 31, 2015 the interest rate is 7.5%, compounded daily.[22] Penalties are charged in addition to interest. The maximum penalty is 25% of the tax due. Under Tax Law Section 258, the penalty can be waived by the Department if it finds that the mortgage was recorded in good faith.[23]

Often asked is whether a mortgage loses priority over other later arising liens when a deficiency in tax is paid. A case on point is *First Niagara Bank* decided by the Supreme Court, Albany County, in 2008.[24] According to the Court, "…any failure…to pay mortgage tax…would not affect the validity of the mortgage." Therefore, pay the tax, and the mortgage's priority should not be impaired.

Note that mortgage tax is due on recording and is only payable though the recording process.

Title Insurance

Why is this important to a title insurer? One of the Covered Risks under the ALTA Loan Policy is loss or damage sustained by the insured mortgagee if the lien of its mortgage is held to be unenforceable. If the insured mortgage cannot be foreclosed because the proper amount of mortgage tax has not been paid, this Covered Risk will apply.

To further confirm the coverage of the Loan policy, lenders typically obtain a $25 Title Insurance Rate Service Association ("TIRSA") Mortgage Tax Endorsement, stating the coverage even more clearly. The endorsement "insures the owner of the indebtedness secured by the insured mortgage(s) against loss or damage which may be sustained by reason that all mortgage recording taxes required to be paid on the insured mortgage(s) have not been paid."[25]

It is suggested that counsel provide draft mortgage documents to the title company or title agent underwriter in advance of closing to enable review for compliance with mortgage tax requirements. Obtaining an enforceability opinion from counsel on a transaction should not be considered a substitute for title counsel review.

Mortgages

What is subject to tax as a "mortgage"? A mortgage, of course, but a mortgage, for purposes of the tax includes other types of instruments, such as an agreement reflecting a re-advance which is intended to be secured, an executory contract for the sale of real property under which the purchaser is in possession prior to delivery of the deed, and a so-called "negative pledge."[26]

A negative pledge is the borrower's agreement not to transfer, sell, convey or encumber real property while a loan is outstanding. It was used in the 1980s by some lenders in lieu of recording a mortgage since a negative pledge was not then considered taxable. That is no longer the case. A negative pledge on recording is taxable as a mortgage.[27]

An Assignment of Rents recorded in New York City and an Assignment of Leases and Rents, generally, are taxable as mortgages when not recorded as additional collateral security for an obligation secured by a mortgage on which mortgage tax has been paid. The mortgage tax rate applicable to the instrument given as additional collateral security, if it was taxable, must be no greater than the tax rate applicable to the mortgage; otherwise mortgage tax to the extent of the difference in the rates is payable.

Dormant Mortgages

A "dormant" mortgage can be taxable as a new mortgage. According to Real Property Law Section 275, as amended in 1989, a mortgage no longer securing a bona fide obligation is "dormant."[28] If dormant, mortgage tax is due on the further transaction of the mortgage.

To confirm that a mortgage being assigned continues to secure a bona fide obligation, Section 275 requires that the assignment of a mortgage include, or be accompanied by, a statement signed under oath, known as a Section 275 affidavit, affirming that the assignee is not acting as a nominee of the mortgagor and that the mortgage continues to secure a bona fide obligation. Alternatively, if applicable, the assignment can state that "the assignment is not subject to the requirements of RPL Section 275 because it is an assignment within the secondary mortgage market."[29]

When commercial real property is involved, mortgages are typically assigned between lenders in a seemingly never-ending chain of assignments to obtain the benefit of mortgage tax already paid on still outstanding principal indebtedness. However, Real Property Law Section 275 was amended in 1989 to end a practice of assigning an otherwise paid-off, and therefore dormant mortgage to an entity related to the borrower, the mortgage later being assigned to a bona fide, unrelated lender to secure a new loan.[30] Credit for mortgage tax paid on the so-called "warehoused" mortgage would be claimed.[31]

The question often arises as to whether a mortgage is dormant when it is assigned to an entity related to the borrower if the obligation secured continues to be serviced as a real debt. There is no definitive guidance on this issue. However, the Department stated in a 1989 Memorandum that "[n]ew section 275 therefore includes within the substantive prohibition on…an assignment to any person or entity acting at the direction or control or influence, of the mortgagor where the mortgage so assigned no longer serves as security for a bona fide debt."[32]

When is a mortgage clearly dormant? The Department has taken the position, in a Tax Bulletin issued in January of 2014,[33] that a mortgage no longer secures a bona fide debt and is dormant when the mortgagor delivers a deed-in-lieu of foreclosure to the holder of the mortgage, its nominee or designee, even when the deed contains non-merger language and the mortgagee gives a covenant not to sue instead of discharging the debt.

According to the 2014 Tax Bulletin, after delivery of a deed-in-lieu the mortgage can only be foreclosed. Recording an instrument purporting to assign, modify or consolidate a mortgage after a deed-in-lieu requires payment of mortgage tax. It is uncertain whether tax will be due on the entire face amount of the mortgage or on its outstanding balance when tax is due. The Bulletin only states that tax will be due on the "full amount of the debt secured."[34]

Exemptions

No mortgage tax is payable when an exemption from tax is provided by law. An affidavit executed by the exempt entity claiming the exemption must be submitted with the mortgage to the recording office. Based on a 1956 Opinion of New York State's Attorney General, it is technically required that the exempt entity presents the document for recording, and the mortgage should recite that it will do so.[35]

Mortgages made under a Chapter XI Plan of Reorganization are exempt under Bankruptcy Code Section 1146(c).[36] A mortgage made under a different Chapter of the Code, and a mortgage securing debtor-in-possession financing, are not exempt.[37] To obtain the exemption for a mortgage made pursuant to a confirmed Chapter XI Plan, the mortgage must be made by the Debtor, not by an entity related to the Debtor or by a purchaser under a Plan of Reorganization,[38] even if the Plan and Bankruptcy Court Order recite that the mortgage if made by other than the Debtor is exempt from mortgage tax. Advice has been received that it will not allow an exemption in such a case.

When either the mortgagor or the mortgagee is the United States, or the State of New York, or any of their agencies, instrumentalities or political subdivisions, the mortgage is exempt from mortgage tax. Mortgages made by Industrial Development Agencies are exempt, provided, according to conversations with the Department, the loan proceeds are to be used solely within the county in which the IDA is formed. Mortgages made by certain entities formed under the Private Housing Finance Law, such as limited dividend housing companies, housing development fund companies, and limited profit housing companies and redevelopment companies, are exempt. Reverse mortgages complying with the requirements of Real Property Law Sections 280 or 280-a are exempt. The affidavit claiming exemption for a reverse mortgage must set forth the ages of the mortgagors, the type of real property being mortgaged, and affirm that the mortgage complies with the requirements of either Section 280 or 280-a.[39]

Mortgages made by Voluntary Not-for-Profit Hospitals are exempt,[40] although the City of New York requires the submission of certain proofs in addition to the affidavit claiming exemption. A Interdepartmental Memorandum of the New York City Register dated October 21, 1980, requires that the affidavit requesting exemption under Tax Law Section 253-3, signed by an officer of the hospital, be accompanied by a copy of the hospital's certificate of incorporation, its operating certificate from the Department of Health, and a certificate from the Public Health Counsel. It is believed that the latter requirement no longer applies.

While not an exemption, there is a credit afforded under the Section 339-ee(2) of Real Property Law Article 9-B (the "Condominium Act") for an individual unit mortgage on the first sale of a condominium unit for the part of the tax that was paid on recording a construction mortgage or another form of blanket mortgage at the property. To obtain the credit, the proceeds of the mortgage must have been used for either construction of the condominium, for capital expenses for the development or operation of the condominium, or for the purchase of the land or buildings, provided that the purchase occurred no more than two years prior to the recording of the Declaration. In addition, to obtain the credit, a unit, any unit, must be sold within two years following recording of the construction or blanket mortgage. The affidavit to claim the credit, which does not include a credit for the Special Additional Tax, is complex. Title underwriters can assist in preparing the form. In practice, the benefit of the credit typically goes to the condominium's Sponsor.

It is often asked whether an exempt mortgage, fully funded, if assigned and modified, remains exempt. The applicable aphorism is "once exempt, always exempt."[41] It is also often asked whether a mortgage to an exempt entity can be assigned and funded by a non-exempt entity. Advisory Opinions issued by the Department indicate that the exempt mortgage can be funded by the assignee so long as the mortgage states that the exempt entity will record the mortgage.[42]

There is an exception, however, to the general rule that a mortgage "once exempt [is] always exempt." The exception may apply when later advances are made on a mortgage executed pursuant to a confirmed Chapter XI plan of reorganization. According to a 2011 Tax Bulletin issued by the Department, "…advances through the date of the final decree closing the bankruptcy case are presumed to be [necessary for the completion of the Plan and] exempt.[43] Unless it can be shown that [advances made after the final decree] are necessary for the completion of the confirmed plan of bankruptcy, [those advances] are subject to the mortgage recording tax…."[44]

It has been suggested that a mortgage securing advances to be made after the case is closed, to be executed pursuant to a confirmed Plan, be brought to the Department's attention before the mortgage is executed to consider whether the later advances will be exempt.

Supplemental Mortgages

Under Tax Law Section 255, the recording of an instrument is exempt from mortgage tax as a "Supplemental Mortgage," except to the extent that an obligation is also being secured on which tax has not been paid. A so-called "Section 255 Affidavit," executed by "the mortgagor, the mortgagee, or any other person who has knowledge of the facts," is submitted with the Supplemental Instrument to claim exemption. The affidavit will recite, among other things, that there is no further indebtedness or obligation being secured by the supplemental mortgage.[45]

A document is supplemental if it is being recorded to correct or perfect a recorded mortgage. A mortgage severance agreement and its resulting substitute mortgages, if the mortgage provides for severance, are also supplemental. (A mortgage is modified prior to severance to allow it to be severed into substitute mortgages.) Other common supplemental instruments include a modification agreement and a consolidation agreement, to the extent of outstanding principal secured on which tax was already paid, and a mortgage or an assignment of leases and rents given as additional collateral security for an obligation secured by a mortgage on which tax was paid. Types of instruments considered supplemental are listed at 20 NYCRR 645.1.

If supplemental, and there is no new indebtedness being secured,

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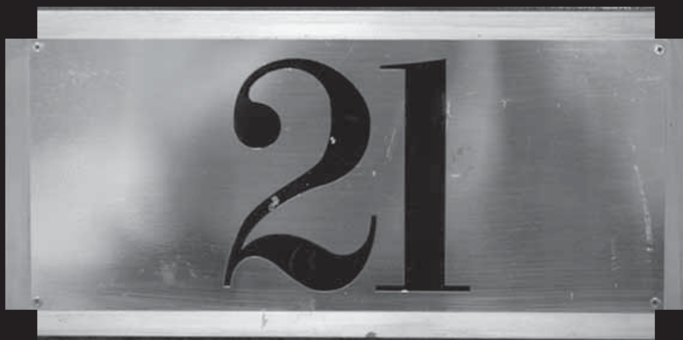

Scenes from the Real Property Law Section

Annual Meeting

Cocktail Reception/Luncheon

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mortgage tax will only be due if the rate of tax in the jurisdiction in which the additional collateral security instrument is being recorded is greater than the tax rate in the county in which the primary mortgage, the mortgage for which the new instrument is being given as additional security, was recorded. Tax is payable based on the spread between the rates if the rate of tax is greater in the location where the collateral security instrument is being recorded.[46]

Spreaders

An agreement spreading the lien of a mortgage to other real property when both parcels are outside of New York City is treated as a supplemental instrument provided that the rate of tax in the jurisdiction to which the mortgage is to be spread is no greater that the rate of tax that applied where the primary mortgage was recorded. If the mortgage tax rate in the jurisdiction to which the mortgage is being spread is higher, payment of the difference in tax must be submitted with a Section 255 Affidavit to record the spreader agreement.

However, Tax Law Section 255 was amended in 2004 to limit the spreading of mortgages involving real property located in New York City. The change was effective as to mortgages recorded in New York City on and after January 17, 2005. Tax Law Section 255 allows the Department to "disregard such transfers" if a spreading agreement has "been undertaken for the purpose of avoiding or evading [the payment of mortgage tax] rather than solely for an independent business or financial purpose."

A Technical Memorandum ("Memorandum") was issued by the Department in November 2004 to explain how Tax Law Section 255 is to be applied to agreements spreading the lien of mortgages which encumber real property in New York City. As noted in the Memorandum,[47] the Section 255 Affidavit submitted to the recording office with the agreement spreading the lien of the mortgage should state "the independent business or financial purpose for undertaking the spreading agreement" and that "the mortgagor/obligor named under the primary recorded mortgage will not be released from the evidence of the indebtedness (e.g. the note) secured by the mortgage…."[48]

Unfortunately, a number of issues were not clearly addressed. For example, is there a safe harbor period of time, after which the original obligor may be released? Can a spread mortgage be released from the real property originally encumbered? If not, is there a safe harbor following which the release of that property will be allowed? Is mortgage tax, when imposed on the recording of an agreement spreading the lien of the mortgage, computed on the amount of the outstanding principal balance of the mortgage when the spreader agreement is executed or on its original face amount? What constitutes an "independent business or financial purpose"? Is a mortgage spread from real property outside of New York City to real property within New York City, and a mortgage spread from real property within New York City to real property outside New York City, subject to these spreader rules?

Further, a mortgage can be spread to an interest in real property owned by a natural person or an entity "related" (defined in Tax Law Section 253-a-2(b), as modified in Tax Law Section 255-1(a)(ii)), to the original mortgagor, which includes an entity which has beneficial interests of 25% or more in common with the mortgagor.[49] However, as stated in the Memorandum, there is a rebuttable presumption that "the transfer of a property to a related party…is for a tax avoidance purpose if the transfer occurs within 12 months prior to the recording of the mortgage spreader." In such a case, if the presumption is not satisfactorily "rebutted by clear and convincing evidence that the transfer of the property to the related party is not for a tax avoidance or evasion purpose," mortgage tax will be due on the recording of the spreader agreement.

A further written statement from the Department, cogently setting forth the rules applicable to spreader agreements with examples of how they are to be applied, would be helpful.

Taxable Amount

Under Tax Law Section 253, mortgage recording tax is computed based on the "principal debt or obligation which is, or under any contingency, may be secured at the date of execution thereof or at any time thereafter by a mortgage on real property."[50] This would, for example, require mortgage tax to be paid on recording an instrument reciting that a property in New York is being pledged as additional collateral security for a debt otherwise secured only by a mortgage or deed of trust recorded in another state. New York's mortgage tax would not have been paid on the out-of-state recording.

If a mortgage secures an indeterminate amount, mortgage tax is computed on the fair market value of the mortgaged real property when the mortgage is recorded.[51] Such a mortgage is referred to as an "Indefinite" or a "Dragnet" mortgage. Reciting that the mortgage secures other debt which may later be owed by the mortgagor to the mortgagee renders a mortgage indefinite, even if the amount to be secured at any one time will be no greater than the amount of the mortgage. An example of such problematic text can be as simple as "this Mortgage is intended to secure any more debts now and/or in the future owed by the Mortgagor to the Mortgagee."

A mortgage may secure other amounts relating to the ongoing administration of the loan and the maintenance of the property. To prevent any such recitals, or a future advance clause, from rendering a mortgage indefinite, at least at the time of recording, and to set forth the amount on which tax will be computed on recording, it is standard practice for a mortgage to include a so-called maximum amount clause.[52] An abbreviated form of such clause is the following: "Notwithstanding anything contained herein to the contrary the maximum amount or principal indebtedness secured by this Mortgage at the time of execution hereof or which under any contingency may become secured by this Mortgage at any time hereafter is $[the amount on which mortgage tax is being paid]."[53]

State regulations, and forms of maximum amount clauses approved by the Department, indicate that certain types of expenses incurred by the lender can be secured without rendering a mortgage indefinite. These are often referred to as "incidental amounts."[54] Payments by a mortgagee which can be secured without additional tax include its payment of real estate taxes and insurance premiums on the mortgaged property subsequent to an event of default and expenses incurred by a mortgagee in litigation to uphold the lien of the mortgage.[55] Unpaid interest, so long as not added to or otherwise deemed principal indebtedness, can also be secured. Expenses incurred by the mortgagee for capital improvements at the mortgaged property are not incidental amounts.[56]

Unpaid interest added to principal, also referred to as negative amortization or capitalized interest, is subject to tax. If the amount of unpaid interest which may be added to principal indebtedness is not expressly capped the mortgage will be rendered indefinite. Mortgage tax is therefore typically also paid on an additional, and expressly capped, amount of negatively amortized interest. The charging of interest on unpaid mortgage loan interest may be treated the same as adding interest to principal.

Certain other rights of a mortgage lender can be secured without rendering a mortgage indefinite, such as shared appreciation and other equity kickers, and breakage costs under a SWAP Agreement, provided these rights are secured as Additional Interest, and not as additional principal indebtedness.

Swap Agreements

Under a January 2012 Tax Bulletin, breakage costs under a so-called SWAP Agreement, when secured, are considered incidental, provided that they are not secured as principal and certain conditions are met.[57] First, breakage costs must be secured as Additional Interest. Second, the SWAP agreement must relate only to the related mortgage loan. Third, the notional amount of principal under the SWAP Agreement must be no greater than the principal amount secured by the mortgage. (As discussed with the Department, the Tax Bulletin states in error "the same as" the principal amount secured.)

The Tax Bulletin also states that the SWAP provider must be the same as the mortgagee. From conversations with the Department, the SWAP provider can be an affiliate of the mortgagee.

Partial Security

An issue that frequently arises is the application of mortgage tax to a mortgage which partially secures a single obligation larger than the amount secured, whether it is a term loan being partially secured or a mortgage securing a revolving line of credit that does not receive the benefits of Tax Law Section 253-b, which will be discussed below.

On which dollars is mortgage tax paid? To enforce a mortgage as to all amounts intended to be secured, mortgage tax is required to be paid on all such amounts. In 1993, the State resolved this issue for a mortgage partially securing a single obligation in its Advisory Opinion regarding the application of BT Commercial Corporation.[58]

The Opinion set forth what is required when securing part of a single, larger obligation. First, the mortgage must contain a maximum amount clause, setting forth the maximum amount to be secured at any one time, on which amount mortgage tax is paid at recording. Second, the mortgage must identify the part of the loan which is being secured. The mortgage needs to recite, for example, that it secures the first dollars advanced, or a portion thereof, and the last dollars repaid. This is set forth in what is known as a "last dollar" clause.

The "last dollar" clause effectively renders a mortgage securing part of a revolving line of credit as security for a term loan. The amounts secured are the first advanced or a portion thereof and the last repaid; the credit line is not paid down below the cap until the loan is to be repaid in full.[59]

This issue does not exist when the protection of Tax Law Section 253-b applies.

Credit Line Mortgages

Under Tax Law Section 253-b ("Credit line mortgages"), all advances and re-advances under a revolving credit mortgage are secured and the mortgage is enforceable as to those advances and re-advances, up to the stated maximum amount secured at any one time, without payment of further mortgage tax, when the mortgaged real property is principally improved or to be improved by a 1-6 family owner-occupied residence regardless of the mortgage amount, or the mortgage, often referred to as a commercial credit line mortgage, "secures less than $3,000,000," regardless of the type of real property mortgaged.[60]

For a credit line mortgage on an owner-occupied 1-6 family residence, the original mortgagor must be a natural person. If the real property is transferred to a person or persons not related to the original obligor by blood, marriage or adoption, or to a trust in which 50% or more of the beneficial interests are held by the transferor, mortgage tax will be payable as if there is a new mortgage. That is the reason that New York State's transfer tax return, the TP-584, includes a Credit Line Mortgage Certificate asking if the real property is being transferred subject to a credit line mortgage and, if so, whether it is being transferred to a related party.

Unfortunately, in going beyond the four corners of Section 253-b, the Department, particularly in a Memorandum issued in 1999, has limited application of the statute.[61] For example, the mortgagor and the obligor must be the same to obtain the benefits of Section 253-b. If the mortgage is given by a guarantor, Section 253-b does not apply, and the mortgage must contain a last dollar clause, as previously discussed.

To receive the benefits of Section 253-b a mortgage must have originally been a credit line mortgage. A term loan cannot be converted to a credit line to obtain the benefits of the statute. For Section 253-b to be applied to a commercial credit line mortgage, the aggregate amount outstanding at any one time under the credit line must be less than $3,000,000, regardless of whether the mortgage sets forth that such amount is the maximum amount secured at any one time.

In addition, if there is another mortgage on the same real property the principal amounts of the mortgages may be aggregated if the loans are not "separate and distinct." If the aggregated amount outstanding at any one time may be $3,000,000 or more, the credit line mortgage, even if its maximum amount clause is less than $3,000,000, will not receive the commercial credit line benefits of Section 253-b. What is separate and distinct? Unfortunately, there is little guidance. What if there is also a term loan secured by a separate mortgage? Are the credit line and term loan mortgages separate and distinct if there are separate loan agreements? They probably are, but each case will turn on its unique facts.

What is clear, however, from the 1999 Memorandum, and from discussions with the Department, is that cross-defaulted or cross-collateralized mortgages are not "separate and distinct." Section 253-b does not apply when a credit line mortgage otherwise entitled to the benefits of Section 253-b and another mortgage are cross-defaulted or cross-collateralized.

If a mortgage securing a revolving line of credit does not receive the benefits of Section 253-b, to limit the amount of tax payable to the amount set forth in the maximum amount clause, the mortgage must identify the loan proceeds secured, such as being the first dollars advanced or a portion thereof, and include a "last dollar" clause.[62]

Guarantee Mortgages

There was a time when a mortgage securing a guarantee of a revolving line of credit could recite that the amount secured was the guaranteed amount, a fixed sum. Mortgage tax would be charged only on that amount, not on re-advances under the underlying loan.[63] That has not, however, been the case for a number of years. A mortgage securing a guarantee is subject to mortgage tax in the same manner as if the mortgage was made by the obligor under the credit line. The benefits of Tax Law Section 253-b are not available to a mortgage securing a guarantee of a revolving line of credit since the obligor and the mortgagor are not the same.[64]

Accordingly, for a mortgage securing a guarantee of a revolving line of credit, mortgage tax is payable on re-advances when recording a supplemental instrument evidencing a re-advance, unless the mortgage contains maximum amount secured and last dollar clauses. Further, the requirements applicable to a mortgage partially securing a single, larger obligation apply.

Partially Securing Multiple Obigations

In a Tax Bulletin dated January 7, 2013,[65] the Department addressed "Mortgages Partially Securing Multiple Debts or Obligations." Before this Bulletin was issued, there was no written guidance on how to apply mortgage tax to a mortgage securing multiple obligations, the sum of which is greater than the mortgage's maximum amount clause. A mortgage may secure, for example, a combination of term and revolving credit loans, an agreement to reimburse lenders issuing letters of credit, and guarantees of loans made to an entity other than the mortgagor. As noted above, mortgage tax is required to be paid on each obligation secured by a mortgage for all of the obligations secured to be enforced.

The Tax Bulletin states that, yes, a mortgage partially securing multiple obligations must contain a maximum amount clause to set the amount of tax payable on recording. However, the maximum amount secured, or the "cap," is to be allocated among the obligations. If the allocation is not set forth in the mortgage, the cap will be prorated.

For example, a mortgage has a maximum amount clause of $10,000,000; mortgage tax is paid at recording on $10,000,000. The mortgage states that it secures a term loan of $20,000,000 and a revolving line of credit of $20,000,000. If the $10,000,000 cap is not allocated in the mortgage, the mortgage is deemed to secure, for application of mortgage tax, $5,000,000 of the term loan and $5,000,000 of the revolving loan and is enforceable on recording only to that extent. Since the mortgage secures each loan for $5,000,000, each of the term loan and the revolving loan secures and is enforceable without the payment of additional mortgage tax up to $5,000,000.

According to the Tax Bulletin, when there is a paydown of a partially secured obligation, mortgage tax can be paid on an additional portion of the obligation to secure and render enforceable all or part of that further amount, up to the amount of the allocated cap. Tax is payable on recording a supplemental instrument.

In the above example, $10,000,000 of the $20,000,000 term loan is advanced at closing, and then $3,000,000 of the term loan is repaid. Assuming the mortgage states that the amounts secured are the first sums advanced or a portion thereof, the $3,000,000 repayment is applied against the amount on which mortgage tax was paid. The amount under the allocated cap of $5,000,000 is therefore reduced by $3,000,000 to $2,000,000. After the $3,000,000 re-payment, there is still $7,000,000 of the term loan outstanding since $10,000,000 was advanced. Mortgage tax can be paid on an additional $3,000,000 of that $7,000,000 since there is $3,000,000 outstanding of the amount on which tax was paid under the $5,000,000 allocated cap.

On payment of mortgage tax on the additional $3,000,000, the mortgage again secures, for application of the mortgage tax, and is enforceable as to the term obligation, to the extent of $5,000,000, the amount of the cap allocated to the term loan.

As to the $20,000,000 revolving obligation, again, the allocated cap is $5,000,000. Ten million dollars of the revolving amount is advanced at closing and then $3,000,000 is repaid. Assuming the mortgage states that the amounts secured are the first sums advanced or a portion thereof, the $3,000,000 repayment is applied against the amount on which mortgage tax was paid. The amount under the allocated cap of $5,000,000 is therefore reduced by $3,000,000 to $2,000,000. After the $3,000,000 repayment there is still $7,000,000 of the revolving loan outstanding since $10,000,000 was advanced. Tax can be paid on an additional $3,000,000 of that $7,000,000 since there is still $2,000,000 outstanding of the amount on which tax was paid under the $5,000,000 allocated cap.

On payment of mortgage tax on the additional $3,000,000, the mortgage again secures, for application of the mortgage tax, and is enforceable as to the revolving obligation, to the extent of $5,000,000, the amount of the cap allocated to the revolving loan.

As a further example, when the allocation of the cap takes a bit more math, a mortgage purports to secure a term loan of $6,000,000 and a revolving loan as to which the maximum amount advanced at one any time is $10,000,000. The maximum amount at any one time secured by the mortgage, the "Cap," is $6,000,000. Two obligations are therefore partially secured by the mortgage. Assuming that the mortgage does not expressly allocate the Cap between the obligations, the Cap is allocated by applying the formula, Loan/Total Debt X Cap.

As to the Term Loan, the mortgage is deemed to secure, for application of the mortgage tax, and is enforceable, to the extent of $2,250,000, which results from application of the formula to allocate the cap as follows: $6,000,000 Term Loan/Total Debt of $16,000,000 ($6,000,000 Term Loan and the $10,000,000 maximum amount outstanding at any one time under the revolver) X $6,000,000 Cap.

As to the Revolving Line of Credit, the mortgage is deemed to secure, for application of the mortgage tax, and is enforceable, to the extent of $3,750,000, which results from application of the formula to allocate the cap as follows: $10,000,000 maximum amount outstanding at any time under the revolving line of credit/Total Debt of $16,000,000 X $6,000,000 Cap.

Applying the Bulletin to the revolving line of credit, assume that $4,000,000 of the revolving loan is advanced at closing and then $1,400,000 is repaid. Assuming further that the mortgage states that the amount secured is the first sums advanced or a portion thereof, the $1,400,000 payment is applied against the amount on which mortgage tax was paid. The cap of $3,750,000 is deemed reduced by $1,400,000 to $2,350,000. Assume that another $5,000,000 is re-advanced under the revolver such that there is $7,600,000 outstanding under the revolving obligation. Of that amount, an additional $1,400,000, up to the $3,750,000 allocated cap, can be secured on the payment of additional mortgage tax.

On paying mortgage tax on that additional $1,400,000, tax will have again been paid up to the cap of $3,750,000. The mortgage as to the revolving obligation again secures, for application of the tax, and is enforceable as to the revolver, to the extent of $3,750,000, the amount of the cap allocated to the revolving loan.

To summarize, when a mortgage partially secures more than one obligation; that is, when mortgage tax is not paid on the aggregate amount of all advances intended to be secured or when there is not a separate maximum amount clause and "last dollar" provision as to each obligation, the Tax Bulletin requires that the mortgage (i) contain a maximum amount secured provision on which mortgage tax will be paid on recording; (ii) identify the portion of each obligation that may be enforced under the maximum amount provision or there will be a deemed allocation, and (iii) include a statement that the mortgage secures an identifiable portion of the loan, such as the first sums advanced or a portion thereof. The Tax Bulletin also states that the mortgage must include "last dollar" text, which, again, is to the effect that the last and final payments will be applied to reduce and satisfy the secured portion of the mortgage debt. Applying the "last dollar" concept to a mortgage partially securing multiple obligations may be an anomaly, but the Department appears to have issued the Tax Bulletin relying, in part, on its BT Commercial Advisory Opinion.

The rules set forth in the Tax Bulletin may apply when one of multiple obligations intended to be secured is already secured by a separate mortgage on which mortgage tax has been paid. To avoid this issue, a mortgage securing a primary obligation, on which tax is due, should not also collaterally secure a different debt as additional collateral security. A separate mortgage should be executed to secure only the collateral obligation; as a supplemental instrument it will be exempt from tax as having been given as additional collateral security for an obligation on which mortgage tax was already paid.

While the Tax Bulletin may not be applied to mortgages partially securing multiple obligations which were recorded before the Bulletin was issued, it is believed that the Bulletin will be applied to such mortgages when they are later modified so as to add to or otherwise change the obligations secured.

Other Issues

There are other mortgage recording tax-related issues beyond the scope of this article, such as the application of mortgage tax to a wrap-around mortgage,[66] to the refinancing of a wrap-around mortgage,[67] and to the defeasance of a secured obligation prior to the assigning the note and mortgage.[68] An experienced New York title underwriter should be consulted when a transaction is being structured.

Resources

Information on mortgage recording tax can be found in State regulations at 20 NYCRR Part 640. In addition, the Department, which administers the tax, has posted to its website (at http://www.tax.ny.gov/pubs_and_bulls/) a number of Advisory Opinions, Notices, Tax Bulletins and Technical Memoranda, some of which have been cited in this article. Most of the Tax Bulletins on mortgage recording tax, and on the state's transfer tax, have been issued in response to questions posed by the New York State Land Title Association.

Endnotes

1. Matter of S.S. Silberblatt, Inc. v. Tax Comm'n, 5 N.Y.2d 635, 159 N.E.2d 195, 186 N.Y.S.2d 646 (1959).
2. Major fraction means that there is rounding. If the mortgage amount is $1,050, tax is payable on $1,000; if the mortgage amount is $1,050.01, tax is payable on $1,100.
3. Mortgage tax rates are set forth on Form MT-15 ("Mortgage Recording Tax Return") posted by the Department at http://www.tax.ny.gov/pdf/current_forms/mortgage/mt15.pdf.
4. Annual Statistical Report of New York State Tax Collections, Office of Tax Policy Analysis, NYS Department of Taxation and Finance, http://www.tax.ny.gov/research/stats/statistics/new_reports.htm.
5. N.Y. Dep't Tax & Fin. Adv. Op., TSB-A-14 (1) R (July 2, 2014), 2014 WL 3676456. Endnotes with TSB and TB refer to guidance issued by the Department, posted at http://www.tax.ny.gov/pubs_and_bulls/.
6. N.Y. Tax Law § 253-a (1) (McKinney 2014).
7. 20 N.Y. Comp. Rules & Regs. § 642.4(c)(3) (1994); *see also*, Michael J. Berey, *Tax Aggregation Rules: Traps for the Unwary*, N.Y.L.J., Sept. 30, 2002 at 5.
8. N.Y. Tax Law § 253(1) (McKinney 2014).
9. *Id.* at § 253(1-a)(a).
10. *Id.* at § 253(2)(a).
11. *Id.* at § 253(1-a)(b).
12. Dime Savings Bank v. State, 174 A.D.2d 173, 579 N.Y.S.2d 679 (2nd Dep't 1992).
13. Hudson Valley Fed. Credit Union v. Dep't of Taxation and Fin., 28 Misc. 3d 1001, 906 N.Y.S.2d 680 (Sup. Ct., NY County 2010).
14. N.Y. Tax. App. Trib. Technical Memorandum, TSB-M-12 (1) R (December 6, 2012) WL 6218357.
15. N.Y. Dep't Tax & Fin. Memorandum, TSB-M-10 (1) R (March 30, 2010) WL 1280302.
16. 20 N.Y. Comp. Rules & Regs. § 642.3 (2014).
17. 20 N.Y. Comp. Rules & Regs. § 642.2 (2014); *see* Tax Bulletin MR-5 (TB-MR-5), July 5, 2012.
18. http://www.tax.ny.gov/pdf/current_forms/mortgage/mt15.pdf.
19. N.Y. Tax Law § 258 (McKinney 2014).
20. Commonwealth v. Lituchy, 555 N.Y.S.2d 786 (1st Dep't, 1990).
21. N.Y. Tax Law § 258 (McKinney 2014).
22. http://www.tax.ny.gov/pay/all/int_curr.htm.
23. N.Y. Tax Law § 258 (McKinney 2014).
24. First Niagara Bank v. Aspen Hills II, LLC, 862 NYS 2d 814, 19 Misc. 3d 1121(A) (Sup. Ct., Albany Co. 2008).
25. http://www.tirsa.org/TIRSA_Rate_Manual_070111_copyrighted.pdf.
26. N.Y. Tax Law § 250; 20 N.Y. Comp. Rules & Regs. § 641.6.
27. TSB-M-95(1)-R (August 9, 1995).
28. TSB-M-89 (6.1)R (August 3, 1989).
29. N.Y. Real Prop. Law § 275 (McKinney 2014).
30. TSB-M-89 (6.1)R (August 3, 1989).
31. *Id*.
32. TSB-M-89 (6.1)R (August 3, 1989).
33. MR-575 (TB-MR-575), January 6, 2014.
34. *Id*.
35. 1956 Att. Gen (Inf. Opns.) 27. See also TSB-A-95(15)-R , December 18, 1995.
36. 20 N.Y. Comp. Rules & Regs. § 644.1 (2011).
37. TB-MR-165, November 18, 2011.
38. In Re Amsterdam Development Associates, 103 B.R. 454 (Bankr. S.D.N.Y., 1989).
39. N.Y. Tax Law §§ 252, 252-a; 20 N.Y. Comp. Rules & Regs. § 644.1 (2011).
40. N.Y. Tax Law § 253.3.
41. TSB-A-95(6)-R, July 6, 1995.
42. TSB-A-97(4)R, March 28, 1997; TSB-A-95(16)R, December 22, 1995.
43. TB-MR-15, November 18, 2011.
44. *Id*.
45. 20 N.Y. Comp. Rules & Regs. § 645.3 (2014).
46. 20 N.Y. Comp. Rules & Regs. § 645.2 (2014).
47. TSB-M-04(9)R, November 22, 2004; the Technical Memorandum also dealt with "Amendments to Section 250 of the Tax Law related to wraparound mortgages." See also Berey, *New Law Requires Added Payment for Spreader Agreements*, N.Y.L.J. March 9, 2005. Based on Tax Bulletin Question and Answer "3" as to spreading agreements, and information then received from the Department, the article states that a spreader "may be" subject to tax "if the original mortgagor is released from the obligation or its property is released from the lien of the mortgage at any time after the spreader is recorded."
48. TSB-M-04(9) R (November 22, 2004).
49. *See* N.Y. Tax Law § 253-a(2)(b); N.Y. Tax Law § 255(1)(a)(ii). Example (e) in the Answer to Question "9" in TSB-M-04(9) R references "a 50% test of ownership" which merits an explanation since Section 255(ii) sets forth a 25% common interest standard to be applied in determining if there is a related party.
50. N.Y. Tax Law § 253 (McKinney 2010).
51. *See* N.Y. Tax Law § 256 (McKinney); *see also* State Bank of Albany v. Fioravanti, 51 N.Y.2d 638, 650 n.1, 417 N.E.2d 60, 66 n.1, 435 N.Y.S.2d 947, 953 n.1 (1980).
52. *See* Nat'l Bank of Stamford v. Recreational Acreage Exch. Ltd., 223 A.D.2d 153, 155, 644 N.Y.S.2d 600, 601-02 (3d Dep't 1996).
53. 20 N.Y. Comp. Rules & Regs. § 648.2(a)(2)(ii).
54. *See* 20 N.Y. Comp. Rules & Regs. § 648.2(a)(2).
55. *See* New York ex rel. Title Guarantee & Trust Co. v. Grifenhagen, 156 A.D. 854, 856, 141 N.Y.S. 1044, 1045 (1st Dep't 1913), *aff'd*, 209 N.Y. 569 (1913).
56. Rockefeller Center v. State Tax Commission, 8 A.D.2d 657, 657, 185

N.Y.S.2d 82, 84 (3d Dep't 1959). The mortgage provided that the mortgagee could install a separate refrigeration plant if the mortgagor failed to do so; the cost incurred was to be secured by the mortgage.

57. *See* TB-MR-30 (June 5, 2012).

58. TSB-A-93(15) R (September 3, 1993).

59. *See* Michael J. Berey, *The Last Dollar Endorsement and Capping the New York Mortgage*, N.Y. L.J., Oct. 11, 1995, http://www.firstamny.com/doc/614.pdf. The discussion of the Last Dollar endorsement to a 1992 ALTA Loan Policy does not apply to a 2006 ALTA Loan Policy.

60. N.Y. Tax Law § 253-b.

61. TSB-M-99(1) R (June 25, 1999).

62. *See* Michael J. Berey, *Commercial Credit Line Mortgages and Mortgage Recording Tax*, N.Y.L.J., July 27, 2011, http://www.newyorklawjournal.com/id=1202508332073/Commercial-Credit-Line-Mortgages-and-Mortgage-Recording-Tax?slreturn=20150022202442; Michael J. Berey, *Department of Taxation and Finance Rulings on Commercial Credit Line Mortgages*, N.Y. R.P.L.J., Fall 1999, http://www.firstamny.com/doc/605.pdf; and Michael J. Berey, *Credit Line Mortgages in New York*, N.Y. L.J., Feb. 17, 1999, http://www.firstamny.com/doc/604.pdf.

63. TSB-A-95(13) R (October 3, 1995).

64. TB-MR-570 (January 6, 2014).

65. TB-MR-570 (January 6, 2014); *see also* Michael J. Berey, *New York's Mortgage Tax—Partially Securing Multiple Obligations*, N.Y. R.P.L.J. Spring/Summer 2013, *available at* LEXIS, 41 NYRPLJ 7.

66. First Fiscal Fund Corp. v. State Tax Commission, 49 A.D.2d 408, 375 N.Y.S.2d 433 (3rd Dep't., 1975), aff'd 40 N.Y.2d 940, 390 N.Y.S.2d 412, 358 N.E.2d 1037, (1976).

67. TSB-M-04(9) R (November 22, 2004).

68. TSB-A-00(1) R (February 25, 2000).

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Southern District Disallows Make Whole Payments and Market Interest Rates in *Momentive* Bankruptcy Proceedings

By Garry M. Graber and Craig T. Lutterbein

Judge Robert D. Drain of the Bankruptcy Court for the Southern District of New York recently issued a bench ruling in the Momentive Performance Materials ("*Momentive*") bankruptcy proceeding that continues two frustrating and expensive trends for secured lenders on the issues of "make whole" payments and cram-down interest rates.[1] In that case, Momentive filed a plan of reorganization that proposed to repay certain senior note holders in full but without a make whole payment that the note holders argued was required under the indenture executed by Momentive and at an interest rate below the prevailing market.[2] Although the note holders objected to confirmation, Judge Drain held that Momentive (i) did not have to pay the make whole payment, and (ii) was not required to pay interest at market but rather only as calculated in accordance with the formula set forth in the Supreme Court's decision in *Till v. SCS Credit Corp.*[3] Based on that ruling, Judge Drain confirmed the Plan.[4] As a result, the note holders lost approximately $200 million in make whole payments and received replacement notes with below market interest rates, thus furthering their losses.[5]

By way of background, pre-petition, Momentive issued $1.1 billion in first lien notes and $250 million in so called "1.5 lien notes." Pursuant to the indenture, Momentive was permitted to repay both the first lien and 1.5 lien notes in full prior to maturity. However, if it did choose to pay the notes early, Momentive was required to pay a portion of the interest that would have accrued on the notes if they had not been paid early. On Momentive's petition date, both sets of notes were oversecured.

In its chapter 11 proceedings, Momentive filed a Plan that proposed to cram-down the note holders by repaying the notes in full through the issuance of replacement notes. Momentive, however, only proposed to distribute new notes in the amount of principal and interest due on the notes as of the effective date of the Plan and did not propose to pay the make whole payment in any manner. Momentive also proposed to repay the new notes at a below market interest rate based on the prime rate plus a small increase for risk. In response to this proposed treatment, the note holders voted against the plan and filed objections claiming that the treatment afforded to them was not "fair and equitable" as required to cram-down a secured creditor by section 1129(b) of the Bankruptcy Code.[6]

In determining that the note holders were not entitled to the make whole payment, Judge Drain focused on the fact that the note holders would not be entitled to the make whole payment outside of bankruptcy under state law.[7] Along with the early repayment provisions, which required the make whole payment, the notes also provided the note holders with the right to non-consensually accelerated payment under the notes upon default.[8] The notes also provided that payment under the notes was to be automatically accelerated in certain circumstances, including Momentive's filing bankruptcy.[9] Accordingly, Judge Drain explained that the interaction between the indenture's early repayment and acceleration terms governed whether the note holders were entitled to the make whole payment.

Judge Drain continued that New York law clearly provides that a lender forfeits its rights to consideration for early repayment if the lender accelerates the balance of the debt without the consent of the borrower. Under New York law, Judge Drain explained, this rule has only two exceptions: 1) if a debtor intentionally defaults to trigger an acceleration specifically to avoid paying the make whole payment; and 2) if the contract clearly and unambiguously requires the make whole payment in the event of an acceleration.[10] Because the indenture in question did not expressly provide that the make whole payment was due upon a nonconsensual acceleration and Momentive did not willfully trigger acceleration simply to avoid paying the make whole payment, Judge Drain held that Momentive was not required to pay the make whole payment.[11]

Judge Drain's decision in *Momentive* is not without precedent. In coming to his conclusion, Judge Drain considered and followed several recent cases holding that make whole payments are not required upon acceleration after a bankruptcy filing unless expressly provided for in the indenture under which the notes are issued. Most significant of these rulings is the Second Circuit's ruling in *U.S. Bank Trust National Association vs. American Airlines (In re AMR Corp.)*.[12] There, the Second Circuit denied bond holders a make whole payment in the *American Airlines* case because, under very similar reasoning to Judge Drain's decision in the *Momentive* case, the indenture did not expressly require that the make whole payment be made after an automatic nonconsensual acceleration of the debt. Accordingly, Judge Drain's decision in *Momentive* is more a continuation of a trend towards disallowing creditor claims for make whole payments rather than novel decision on a matter of first impression. As such, the *Momentive* decision should serve as a clear warning to counsel to carefully draft early repayment and acceleration provisions in indentures if they intend for a make whole payment to be enforceable in bankruptcy, because more likely than not bankruptcy courts will not attempt to distinguish the Second Circuit's holding in *AMR*.

Judge Drain also denied the note holders' objection to the interest rate proposed by Momentive.[13] Rather than require Momentive to pay the then prevailing market interest rate on the new notes, Judge Drain held that the appropriate mechanism for calculating a cram-down interest rate is not the market rate but a formula that considers the current prime rate increased by a small risk factor.[14] Judge Drain's decision, accordingly, applies the formula set forth in the Supreme Court's decision in *Till vs. SCS Credit Corp.*[15] and the Second Circuit's decision in *In Re Valente*.[16] The holding is significant because, despite the fact that, in *Till*, the Supreme Court clearly and unambiguously held the appropriate formula for determining an interest rate under a Chapter 13 plan is prime plus risk, the Court has never held that the *Till* formula is appropriate in the context of Chapter 11 proceedings. The holding is, accordingly, bad news for secured creditors because it signals that debtors will be permitted to replace notes with market or above interest rates with notes with much lower interest rates through cram-down in chapter 11.

Although the *Momentive* decision appears to be a continuation of a trend towards denying make whole payments rather than a novel ruling, Judge Drain's expressed logic with respect to when a make whole payment is waived by a secured creditor does serve as a guide for counsel on how to properly construct prepayment and acceleration terms within indentures. As a result of the ruling, counsel is warned that indentures must clearly and unambiguously provide that make whole payments are required after involuntary accelerations, including involuntary acceleration as a result of bankruptcy, if counsel desires the make whole provisions to be enforced in the bankruptcy context. The *Momentive* decision is also further confirmation that debtors will be able to cram-down secured creditors at very favorable interest rates in the Southern District of New York.

Endnotes

1. In re MPM Silicones, LLC, 14-22503-rdd, 2014 WL 4436335, at *5, *16 (Bankr. S.D.N.Y. Sept. 9, 2014).
2. *Id.* at *20.
3. *Id.*; Till v. SCS Credit Corp, 541 U.S. 465, 478–79 (2004) (holding that the prime interest rate plus an additional amount for risk is the interest rate secured creditors are entitled as a result of a chapter 13 cram-down). See also In Re Valenti, 105 F.3d 55, 64 (2d Cir. 1997) (holding that interest rates "should also include a premium to reflect the risk to the creditor in receiving deferred payments under the reorganization plan").
4. In re MPM Silicones, LLC, 2014 WL 4436335, at *1.
5. Id. at *19.
6. Id. at *23; 11 U.S.C. § 1129(b)(2)(A)(i) (2010).
7. In re MPM Silicones, LLC, 2014 WL 4436335, at *16.
8. *Id.* at *13.
9. *Id.*
10. *See, e.g.*, U.S. Bank Nat'l Ass'n v. S. Side House, LLC, 2012 U.S. Dist. LEXIS 10824 (E.D.N.Y. Jan. 24, 2012), at 14-16, 23; Nw. Mut. Life Ins. Co. v. Uniondale Realty Assocs., 11 Misc. 3d 980, 985, 816 N.Y.S.2d 831, 836 (Sup. Ct. 2006).
11. In re MPM Silicones, LLC, 2014 WL 4436335, at *16.
12. In re AMR Corp., 730 F.3d 88, 98-99 (2d Cir. 2013); See also Sharon Steel Corp. v. Chase Manhattan Bank N.A., 691 F.2d 1039, 1049 (2d Cir. 1982).
13. In re MPM Silicones, LLC, 2014 WL 4436335 at *24-25.
14. *Id.* at *25-26.
15. Till, 541 U.S. at 479-80.
16. In re Valenti, 105 F.3d 55, 63-64 (2d Cir. 1997) *abrogated by* Associates Commercial Corp. v. Rash, 520 U.S. 953 (1997).

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Bergman on Mortgage Foreclosures: When a Lender Is Sued (or Not) for Injury at the Mortgaged Premises

By Bruce J. Bergman

The title suggests what seems an anomalous notion. But mortgage lenders and servicers and their attorneys will know and can confirm that mortgage holders are sued on occasion by someone claiming either to have been injured at the mortgaged property or having suffered damage to an adjoining parcel resulting from conditions at the mortgaged property. That generally a mortgage lender or servicer need not worry about losing such a claim is tangentially confirmed by a recent case, *Koch v. Drayer Marine Corporation*, 118 A.D.3d 1300, 988 N.Y.S.2d 233 (4th Dept. 2014), although they might yet have to worry. So there is a dual lesson here.

Before highlighting the meaningful enlightenment that case offers, there is another branch of the equation which can readily create confusion which, in turn, should be addressed.

We speed then to the essence of the underlying concept. If a lender is not in control of the mortgaged premises—the buzzwords are "care, custody and control"—then it will not be liable for events at the property which may cause damage or injury. And, without having become a mortgagee-in-possession, the lender typically would not exercise control over the property and so liability would not be an issue. But then comes an artificial, relatively recently minted, forced obligation of care, custody and control upon mortgagees: the maintenance mandate which can be imposed upon the foreclosing party once the judgment of foreclosure and sale "issues." [For extensive review of this subject, see 3 *Bergman on New York Mortgage Foreclosures*, §27.12, LexisNexis Matthew Bender (rev. 2014).]

Effective as of 2010, and pursuant to RPAPL §1307, under certain (ambiguous) circumstances therein delineated, a foreclosing party of residential property (holding only a lien) can be obliged to maintain the mortgaged premises. If such is the case, then the requisite care, custody and control can emerge together with the unwanted liability which accompanies that dominion.

When the statute was passed, that foreclosing lenders could become liable in tort during the course of a foreclosure was easily predictable. A recent case where a lender may be answerable in damages for deaths by fire at the premises confirms this. [See, *Lezama v. Cedano*, 119 A.D.3d 479, 991 N.Y.S.2d 32 (1st Dept. 2014.]

Thus, an immediate distinction must be made between what might be seen as the "usual" situation—a lender sued where there is no foreclosure judgment—with the factors eliciting the maintenance obligation—and the perhaps less common circumstance of the maintenance obligation having been triggered. The analysis here proceeds regarding the former.

It should be emphasized that if a lender has become a mortgagee-in-possession, although that is a right rarely invoked, it then might indeed be liable for injuries at the property. That (and the mentioned maintenance obligation) aside, the law has always been clear (albeit somewhat obscure) that a lender would need to have exercised some degree of care, custody and control over the property to be liable for torts—generally not applicable to a mere mortgage holder. [For a more expansive review of this concept with case citations, attention is invited to 1 *Bergman on New York Mortgage Foreclosures*, §2.24[9], LexisNexis Matthew Bender (rev. 2014.]

While the first new case cited isn't the precise fact pattern, it nonetheless underscores the critical point. There, a man sued the borrower/owner of the property—a marina—claiming he was injured when a plank collapsed while he was fishing from the dock.

The owner, who was in foreclosure, argued that the judgment of foreclosure and sale in the foreclosure action extinguished ownership so it could not therefore be liable. No, said the court, a judgment does not divest title; only the foreclosure sale does. *But*, the borrower/owner showed that shortly after the foreclosure was begun, she and her staff put the boats in storage and thereafter never had any further contact with the premises. In addition, the foreclosing bank denied the owner's access to remove the boats from storage for the summer season, barred the owner from sending rental renewals to customers and hired another marina operator to take over. This thereby established that the borrower/owner no longer possessed, maintained or controlled the marina.

The applicable principle of law was that "an out-of possession title holder lacking control over the property is not liable for injuries occurring thereon."

It is this maxim which protects a lender who is merely the holder of a mortgage and not in possession. The surprise here, though, was that the injured party did not sue the bank which, it might be argued, *was* in control of the premises through its possible agent, that other marina manager. It can be speculated that such a suit might yet arise.

So, the two lessons:

- A lender or servicer without care, custody and control of mortgaged premises is not liable for injuries occurring there.
- But watch out for consequences if the lender or servicer *does* exercise that care, custody and control—and at the very least, insurance will be needed to protect against such injury claims.

Mr. Bergman, author of the four-volume treatise, *Bergman on New York Mortgage Foreclosures*, LexisNexis Matthew Bender, is a member of Berkman, Henoch, Peterson, Peddy & Fenchel, P.C. in Garden City. He is a fellow of the American College of Mortgage Attorneys and a member of the American College of Real Estate Lawyers and the USFN. His biography appears in *Who's Who in American Law* and he is listed in *Best Lawyers in America* and *New York Super Lawyers*.

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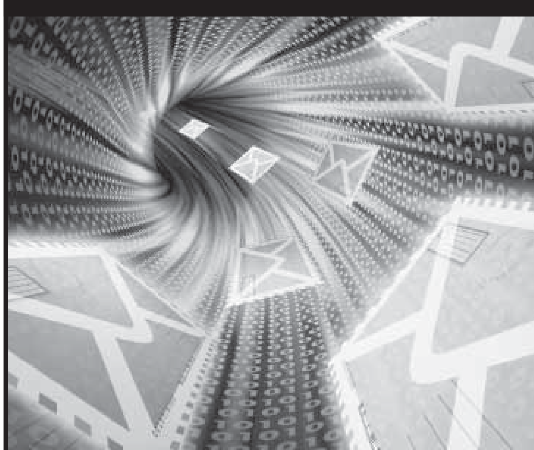

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