

2004 Amendments to the Tax on Mortgages

On August 20, 2004, Governor George E. Pataki signed Chapter 60 of the Laws of 2004. Part Q of this act amended sections 250 and 255 of Article 11 of the Tax Law, Tax on Mortgages, in relation to wraparound mortgages and certain supplemental mortgages recorded in the city of New York. These amendments are effective for such mortgages presented for recording on or after November 18, 2004. This TSB-M represents a joint effort by the New York State Department of Taxation and Finance and the New York City Department of Finance to provide administrative guidance with respect to the new provisions. Since the amendments by their terms are applicable only to mortgages secured by real property located in New York City, it is the position of the Department of Taxation and Finance that the mortgage recording tax will continue to be applied as it was applied prior to these amendments for mortgages secured by real property located outside the city of New York.

Amendments to section 250 of the Tax Law related to wraparound mortgages

Section 250(2) of the Tax Law was amended to require that mortgage recording taxes (MRT) be paid on the recording of a mortgage in the city of New York securing indebtedness the proceeds of which are used to reduce the equity of the holder of a wraparound mortgage or similar mortgage, regardless of whether the indebtedness secured by mortgages on the property is increased or added to.

Q1. What is a wraparound mortgage or similar mortgage for purposes of the new law?

A1. A wraparound mortgage or similar mortgage is a mortgage that provides that the indebtedness secured by the mortgage lien includes the outstanding principal balance of one or more other mortgage debts, which may be referred to as a first or underlying mortgage or mortgages. The mortgage need not be identified as a wraparound mortgage provided the requisite incorporation provisions are present. In a wraparound mortgage, there are two or more separate loans secured by mortgages on the property: the underlying mortgage loan or loans and the wraparound mortgage loan. Although the principal amount of the underlying mortgage loans is included in the principal amount of the wraparound mortgage loan, there are separate lenders and separate obligations. The holder of a wraparound mortgage generally collects the principal and interest on the wraparound mortgage loan, makes the principal and interest payments on the underlying mortgage loans, and is entitled to keep any excess.

Q2. What is the equity of the wraparound mortgage holder for purposes of the new law?

A2. The equity of the wraparound mortgage holder is that portion of the principal amount of the wraparound mortgage debt that represents new or further indebtedness or obligation in excess of the outstanding principal balance of any underlying mortgage "wrapped" by the wraparound mortgage.

The holder of a wraparound mortgage can reduce his equity position to cash by refinancing the underlying mortgage or through new financing. In a typical transaction, the holder causes the wraparound mortgagor to take out a new mortgage loan the proceeds of which are paid to the holder of the wraparound mortgage. The holder of the wraparound mortgage subordinates his mortgage in the amount of the new mortgage loan. The new mortgage is not substituted for the wraparound mortgage, and both debts remain outstanding after the refinancing. The New York State Tax Appeals Tribunal and the courts viewed such transactions as a substitution of one debt for another. That result does not reflect the separate nature of the debt secured by the wraparound mortgage and the debt secured by underlying mortgage. The new law is intended to overturn those decisions to the extent indebtedness secured by mortgages on the property is used to reduce the wraparound mortgage holder's equity position as illustrated by the following examples:

Example 1:

In 2004, Buyer B purchases real property in the city for \$1,000,000 from Seller S. The property is subject to an existing recorded mortgage securing indebtedness having an outstanding principal amount of \$500,000. The proper MRT was paid when the original mortgage was recorded.

S agrees to finance \$800,000 of the purchase price. B pays S \$200,000 cash. S records a wraparound mortgage for \$800,000, which incorporates the \$500,000 mortgage (the underlying mortgage). MRT is paid on the \$300,000 excess of the wraparound mortgage indebtedness over the outstanding principal balance of the underlying mortgage indebtedness. S's equity in the wraparound mortgage is \$300,000. Under the terms of the wraparound mortgage, as principal payments are made on the underlying mortgage, there is a corresponding reduction of the principal balance of the wraparound mortgage.

In 2006, the principal amount of the underlying mortgage has been reduced to \$250,000 and the principal of the wraparound mortgage has been reduced to \$550,000. S causes B to refinance the underlying mortgage for \$450,000. S receives the benefit of \$200,000 cash proceeds of that refinancing and S's equity in the wraparound mortgage is reduced.

The refinancing of the underlying mortgage does not increase the outstanding principal balance of the wraparound mortgage, which in the aggregate remains \$550,000. The \$200,000 reduces S's equity in the wraparound mortgage to \$100,000. Before this transaction, the indebtedness secured by mortgages on the property included the \$550,000 wraparound mortgage and the \$250,000 underlying mortgage. After the refinancing, the indebtedness secured by mortgages on the property consists of the \$550,000 wraparound mortgage and the \$450,000 refinanced underlying mortgage. Under the new legislation, in this example, the MRT is due on the recording of the instrument that reflects the refinanced underlying mortgage indebtedness to the extent of the \$200,000 excess proceeds.

Example 2:

The facts are the same as in example 1 except that instead of refinancing the underlying mortgage, S causes B to borrow \$200,000 from a new lender. The new lender agrees that its loan may be incorporated into the wraparound mortgage, and S agrees to subordinate the lien of the wraparound mortgage to the lien of the new lender. S receives the benefit of the \$200,000 proceeds of the new loan. The wraparound mortgage now wraps around the original underlying mortgage, which has a remaining balance of \$250,000 and the new loan of \$200,000. S's equity in the wraparound mortgage is reduced to \$100,000. Before this transaction, the indebtedness secured by mortgages on the property included the \$550,000 wraparound mortgage and the \$250,000 underlying mortgage. After the refinancing, the indebtedness secured by mortgages on the property consists of the \$550,000 wraparound mortgage, the \$250,000 underlying mortgage and the \$200,000 new loan. Under the new legislation, in this example, MRT is due on the recording of the new mortgage to the extent of the \$200,000 excess proceeds.

Example 3:

The facts are the same as in example 1 except that instead of refinancing the underlying mortgage, S pledges the note and wraparound mortgage to bank L as collateral for a loan of \$200,000. Although S has received the loan proceeds, the equity of the wraparound mortgage holder is unaffected by the transaction. Before this transaction, the indebtedness secured by mortgages on the property includes the \$550,000 wraparound mortgage and the \$250,000 underlying mortgage. After the transaction, the indebtedness secured by mortgages on the property still consists of the \$550,000 wraparound mortgage and the \$250,000 underlying mortgage. No MRT is due. Moreover, S's pledge of the note and wraparound mortgage to bank L as collateral for a loan of \$200,000 does not meet the definition of a mortgage because it does not impose a lien on, or affect title to, real property.

Example 4:

The facts are the same as in example 1 except that, in 2006, to liquidate its investment in the wraparound note and mortgage, S assigns the note and wraparound mortgage to bank L for consideration. Bank L acquires S's equity in the wraparound mortgage and becomes the wraparound mortgagee. The mortgage liens on B's property are unaffected by this transaction other than a recording of an assignment of mortgage to reflect the new owner of the wraparound mortgage, L. Before this transaction, the indebtedness secured by mortgages on the property includes the \$550,000 wraparound mortgage and the \$250,000 underlying mortgage. After the transaction, the indebtedness secured by mortgages on the property still consists of the \$550,000 wraparound mortgage and the \$250,000 underlying mortgage. No MRT is due. The equity of the wraparound mortgage holder is unaffected by the transaction.

Moreover, S's assignment of the wraparound mortgage to bank L does not meet the definition of a mortgage because it does not impose a lien on, or affect title to, real property.

Example 5:

The facts are the same as in example 1 except that, to improve its interest rate on the wraparound mortgage, B locates a new lender, M, willing to take over the wraparound mortgage loan. S agrees to assign the note and wraparound mortgage to M. M acquires the note and wraparound mortgage and S's equity in the wraparound mortgage. The note and mortgage are modified to reflect the reduction in the wrap interest rate. Before this transaction, the indebtedness secured by mortgages on the property includes the \$550,000 wraparound mortgage and the \$250,000 underlying mortgage. After the transaction, the indebtedness secured by mortgages on the property still consists of the \$550,000 wraparound mortgage and the \$250,000 underlying mortgage. Under these circumstances, no MRT is due based on the new amendments to section 250(2) of the Tax Law. The equity of the wraparound mortgage holder is unaffected by the transaction. Moreover, S's assignment of the wraparound mortgage to M does not meet the definition of a mortgage because it does not impose a lien on, or affect title to, real property.

Example 6:

The facts are the same as in example 5 except that B locates a new lender, M, willing to take over the wraparound mortgage loan and the underlying loan. S agrees to assign the note and wraparound mortgage to M. The holder of the underlying mortgage agrees to assign its note and mortgage to M. M acquires both notes and mortgages. The notes and mortgages are modified to reflect the reduction in the interest rate and the consolidation of the mortgages. Before this transaction, the indebtedness secured by mortgages on the property includes the \$550,000 wraparound mortgage and the \$250,000 underlying mortgage. After the transaction, the indebtedness secured by mortgages on the property consists solely of the \$550,000 consolidated mortgage. Under these circumstances, no MRT is due based on the new amendments to section 250(2) of the Tax Law. The equity of the wraparound mortgage holder is unaffected by the transaction. Moreover, neither S's assignment of the wraparound mortgage to M nor the assignment of the underlying mortgage to M meets the definition of a mortgage because neither imposes a lien on, or affects title to, real property.

Amendments to section 255 of the Tax Law related to certain spreading agreements

Section 255(1)(a) was amended to designate the existing provisions as subparagraph (i) and to add new subparagraph (ii). The new provisions in subparagraph (ii) are intended to preclude the avoidance of the mortgage recording tax in the city of New York on the recording of an instrument

that secures a new indebtedness by spreading the lien of an existing mortgage on real property owned by one person to real property owned by another person in connection with a release of the first property from the lien of the existing mortgage and a release of the owner of that first property from any obligation under the indebtedness secured by that recorded primary mortgage. To illustrate:

Example 7:

O owns a parcel of real property in New York City (Property 1). O has given a mortgage on Property 1 to Lender X to secure O's debt of \$100,000, on which the proper MRT has been paid. U is unrelated to O and owns a parcel of real property in New York City (Property 2). If U were to give a mortgage on Property 2 to Lender Y to secure U's debt of \$100,000, the recording of that mortgage would be subject to the MRT. To avoid such tax, the parties, U, O, X and Y, agree to engage in the following transaction:

Step 1: O has a mortgage on Property 1 that was given to Lender X to secure a note of \$100,000. The MRT was paid.

O would like to pay off its obligation for \$100,000. U would like to borrow \$100,000 without incurring MRT.

Step 2: U and O and X record an agreement spreading the lien of the mortgage encumbering Property 1 to U's Property 2.

Step 3: Lender X assigns the mortgage to Lender Y. Lender Y pays Lender X \$100,000 for the assignment.

Step 4: O pays U \$100,000. (Separately, U compensates O for undertaking the transaction, usually based on a fraction of the MRT saved.)

Step 5: Lender Y releases O's Property 1 from the mortgage, and releases O from the obligation and mortgage. Lender Y also amends and restates the note with U as the obligor. Lender Y also records a modification agreement to reflect the fact that U is the mortgagor under a mortgage securing the amended and restated note, which mortgage is collateralized by U's Property 1. As a result, U has successfully borrowed the \$100,000 and has avoided payment of the MRT on this new debt.

The same transaction between U and O, spreading the mortgage from Property 1 to Property 2 and releasing O and Property 1 could be accomplished using a nominee, or similar entity. To illustrate:

Example 8:

The facts are the same as in Step 1 of Example 7. Before Step 2, U, O, and a limited liability company, LLC, enter into a nominee agreement under which LLC will hold the real property as nominee for U and O, and the respective ownership interests remain unaltered. Before the mortgage spreader is recorded, U and O contribute their properties to LLC in exchange for membership interests in LLC. Steps 2 through 5, above, are then implemented. After the necessary steps are completed, the Property 1 would be reconveyed to O, and Property 2 would be reconveyed to U.

These or similar steps may be completed in different variations using a new or existing entity, which might continue to hold one or another of the properties after the transaction, but the results would be the same: O would be released from the obligation and its Property 1 would be released from the mortgage; and U, who is unrelated to O, would be the new obligor under the note and mortgagor under a mortgage now collateralized by U's Property 2.

For liens spread to real property located in the city of New York, the amendments to section 255 of the Tax Law provide that such abusive transactions be identified and MRT collected at the time the spreading agreement is recorded. In addition, the new law contains certain provisions for spreading agreements recorded only in the city of New York. Specifically, new subparagraph (ii) precludes the abusive transactions described above by providing that a recording of a spreading agreement or additional mortgage to include property not covered by or described in the recorded primary mortgage will not be exempt from the tax as a supplemental mortgage where the owner of the new property to be covered is not the mortgagor of the real property originally covered by the mortgage. In addition, subparagraph (ii) is intended to preclude the use of an entity, such as the LLC described above, to achieve the same result, by giving the Commissioner of Taxation and Finance the discretion to disregard certain transfers for purposes of applying the MRT and applying the provisions of subparagraph (ii) as if such transfers had not occurred. For example, in Example 8 above, the Commissioner is authorized to apply the MRT as if the mortgagors of Properties 1 and 2 were O and U, respectively, rather than LLC. (See also Q&A 8.)

Moreover, subparagraph (ii) creates a rebuttable presumption that the transfer of a property to a related party, such as the LLC in Example 8, is for a tax avoidance purpose if the transfer occurs within 12 months prior to the recording of the mortgage spreader. That presumption can be 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.

To determine whether the new provisions apply, in addition to the usual information required by section 645.3 of the Mortgage Recording Tax Regulations, any Section 255 affidavit claiming exemption from tax must expressly state the independent business or financial purpose for

undertaking the spreading agreement or additional mortgage. Furthermore, the affidavit must affirmatively state:

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 and replaced by the mortgagor and the mortgagor's property identified in the instrument used to spread the lien of such primary recorded mortgage.

Q3. What is meant by an additional mortgage for purposes of subparagraph (ii) of section 255(1)(a)?

A3. The phrase spreading agreement or additional mortgage (herein collectively a spreader) refers to (i) any modification of an existing mortgage that spreads the lien of such existing mortgage to another property (a spreading agreement or spreader) and (ii) any modification to an existing mortgage (other than a spreader) whereby, in either (i) or (ii), the original obligor/mortgagor and its property are released from the obligation and mortgage and a new obligor/mortgagor is substituted for the original obligor/mortgagor and the new obligor/mortgagor's property becomes the collateral under the mortgage.

Q4. What is meant by real property described in or originally covered by the recorded primary mortgage for purposes of subparagraph (ii) of section 255(1)(a)?

A4. Real property described in or originally covered by the recorded primary mortgage as security for the mortgage includes real property, as contemplated by section 250(1) of the Tax Law, described by metes and bounds, block and lot, street address or other method commonly used in real property transactions. In addition, real property and interests therein covered by clauses contained in the original recorded primary mortgage such as: all right, title and interest, if any, of the mortgagor in and to the mortgaged premises and all rights appertaining to the use and enjoyment of the mortgaged premises following any such property description will also be considered to be described in or originally covered by the recorded primary mortgage. Moreover, real property included in the security for a mortgage under an after-acquired property clause or blanket mortgage will be considered to be described in or originally covered by the recorded primary mortgage for this purpose.

Q5. What is the definition of the mortgagor of the real property covered by or described in the recorded primary mortgage?

A5. For purposes of subparagraph (ii), real property not covered by or described in the recorded primary mortgage will be considered owned by the mortgagor of the real property subject to the lien of the recorded primary mortgage if the title owner of the new property is the title owner of any real property, or interest therein, covered by or described in the recorded primary mortgage. (But see Q&A 6-8 regarding transfers for tax avoidance purposes, and Q&A 9, describing transactions that

are not intended to be covered by the new amendment.) To illustrate:

Example 9:

Corporation A has a wholly owned subsidiary B. Corporation A borrows \$100,000 secured by a mortgage, which, by its terms, encumbers property 1 owned by corporation A and property 2 owned by subsidiary B. If that mortgage is spread to encumber property 3 later acquired by subsidiary B, the recording of the spreader would not be subject to subparagraph (ii), because B is one of the mortgagors under the recorded primary mortgage. (See also Q&A 9 (f), below.)

Q6. When will a transferee of real property be considered to be related to the transferor/grantor of real property for purposes of the presumption that a transfer is for a tax avoidance or evasion purpose under subparagraph (ii)?

A6. In accordance with Tax Law Section 253-a, the following persons will be considered to be related to the transferor/grantor for purposes of the presumption:

- members of a family, including spouses, ancestors, lineal descendants, and brothers and sisters (whether by whole or half blood);
- a shareholder and a corporation where more than 25 percent of the value of the outstanding stock of such corporation is owned or controlled directly or indirectly by such shareholder;
- a partner and a partnership where more than 25 percent of the capital or profits in such partnership is owned or controlled directly or indirectly by such partner;
- a beneficiary and a trust where more than 25 percent of the beneficial interest in such trust is owned or controlled directly or indirectly by such beneficiary;
- two or more corporations, partnerships, associations, or trusts, or any combination thereof, which are owned or controlled, either directly or indirectly, by the same person, corporation or other entity, or interests; and
- a grantor of a trust and the trust.

Q7. Under what circumstances will the Commissioner of Taxation and Finance view a transfer of property within 12 months of the recording of the mortgage spreader to have been undertaken for a tax avoidance purpose?

A7. The Commissioner of Taxation and Finance generally will view a transfer to a related party as

undertaken for a tax avoidance purpose if the transaction has all of the following characteristics:

- Prior to the transfer, the owner of the real property to be added to the lien of the recorded primary mortgage under the spreader (e.g., U, as transferor of Property 2 in Example 7) was not related to the owner (e.g., O in Example 7) of the real property (e.g. Property 1 in Example 7) covered by, or originally described in, the recorded primary mortgage, within the meaning of Tax Law section 253-a(2)(b), substituting 25 percent for 50 percent where it appears,
- The related party is intended to dispose of its ownership of one or more of the parcels of real property shortly after the spreader transaction is completed subject to the lien of the spread recorded primary mortgage,
- The real property originally covered by or described in the recorded primary mortgage is to be released from the lien of the recorded primary mortgage as part of the spreader transaction and the debtor under the indebtedness secured by the recorded primary mortgage is to be released from all obligations to repay that indebtedness as part of the same transaction.

Q8. What are the consequences if the Commissioner of Taxation and Finance disregards a transfer of property in connection with the recording of a spreading agreement as having been undertaken for a tax avoidance purpose as described in subparagraph (ii) of section 255(1)(a)?

A8. If the Commissioner of Taxation and Finance, or his or her delegate, concludes that one or more of the properties to be covered by a spreader was transferred to the mortgagor for the purpose of avoiding the application of Tax Law section 255(1)(a)(ii), in determining whether the property to become subject to the lien of the spread mortgage is owned by the mortgagor of the property described in or originally covered by the recorded primary mortgage, the Commissioner of Taxation and Finance will consider the person that transferred the property to the mortgagor to be the owner of the property for purposes of subparagraph (ii). If that transferor is not the mortgagor of the property described in, or originally covered by, the recorded primary mortgage, subparagraph (ii) will apply, and (subject to Q&A 9, below), will require the MRT to be paid on a recording of the spreader.

Q9. What types of transactions are not intended to be subject to tax under subparagraph (ii) of paragraph (a) of subdivision 1 of section 255?

A9. Notwithstanding the provisions explained in A7 and A8 above, the provisions contained in Tax Law, section 255(1)(a)(ii) are not intended to adversely affect the recording of mortgage spreading agreements or additional mortgages undertaken for legitimate business purposes, such as the following transactions:

- a. The recording of an instrument extending the lien of the recorded primary mortgage to cover new leases, new improvements, new construction or additional interests, such as easements, on the property described in or originally covered by the recorded primary mortgage.
- b. The recording of an instrument to sever and modify the lien of the recorded primary mortgage to reflect a declaration of condominium ownership or subdivision of the real property.
- c. The recording of an instrument to sever and modify the lien of the recorded primary mortgage to reflect the replacement of construction financing with permanent financing.
- d. The recording of an instrument to spread the lien of a recorded primary mortgage covering real property to be exchanged in a transaction qualifying for nonrecognition of gain under section 1031 of the Internal Revenue Code to the real property to be acquired by the mortgagor in the qualifying exchange.
- e. The recording of an instrument to spread the lien of a recorded primary mortgage where the real property to be added to the lien is owned by a person related to the mortgagor of the recorded primary mortgage within the meaning of Tax Law Section 253-a (using a 50% test of ownership), provided that the original mortgagor/obligor is not released from the debt instrument (e.g., the note) secured by the mortgage.
- f. The recording of an instrument to spread the lien of a recorded primary mortgage to cover property owned by an unrelated party that has agreed with the mortgagee to provide additional collateral for the indebtedness of the original mortgagor, provided that the original mortgagor/obligor is not released from the debt instrument (e.g., the note) secured by the mortgage.

Effective Date

The amendments provided by Part Q of Chapter 60 of the Laws of 2004 in relation to sections 250 and 255 of Article 11 of the Tax Law will apply to mortgages presented for recording on or after November 18, 2004.