



FIDELITY NATIONAL TITLE UPDATES

– BULLETIN –

SEPTEMBER 2004

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SPECIAL EDITION

NYS TO TAX NYC WRAP MORTGAGES, SPREADER AGREEMENTS & ADDITIONAL COLLATERAL MORTGAGES; NYS: COOPS, NONRESIDENTS TO PAY ESTIMATED TAX ON GAIN

On November 18, 2004, important changes to Articles 11 & 22 of the Tax Law, become effective. These changes will impact how mortgages are used to facilitate real estate transactions involving properties within the City of New York. The changes will also affect certain sellers of Coop Apartments, statewide.

As part of the state budget package, the legislature passed and the Governor has signed into law, Assembly Bill number A-9560 (Senate Bill number S-6060). This measure designated Chap. 60, Laws of 2004 amends Article 11, Tax on Mortgages, §§ 250 & 255(Part Q) and Article 22, Personal Income Tax, §§ 631 & 663, (Part H).

I. ARTICLE 11 TAX ON MORTGAGES (PART Q)

a. Wraparound Mortgages:

Applicable to mortgages recorded on or after November 18, 2004, the State of New York will impose mortgage tax on wraparound mortgage transactions on NYC property. Additional language has been added to § 250(A), which defines the term "mortgage." The section as amended makes a "Wraparound mortgage" (wrap mortgages) taxable for the full face amount of the mortgage. Added to subparagraph A of § 250 is the following new language¹ –

§ 250

(A) . . . Notwithstanding anything in this section or section two hundred fifty-five of this article to the contrary, a contract or agreement whereby the proceeds of any indebtedness secured by a mortgage of real property in any city in the state having a population of one million or more are used to reduce all or any part of a mortgagee's equity interest in a wraparound or similar mortgage of such real property shall be deemed a mortgage of real property for

the purposes of this article and shall be taxable as such to the extent of the amount of such proceeds so used, without regard to whether the aggregate amount of indebtedness secured by mortgages of such real property is increased or added to. (Emphasis added).

The result is a mortgage tax on the *full amount of a wrap mortgage*. Previously, mortgage tax need only be paid on the amount of the *new money lent* under the wrap mortgage. The amount of the existing senior mortgage that was wrapped around was treated as exempt from mortgage tax since the applicable tax had been paid on that portion of the debt at the time of its recording.²

Effective as to mortgages recorded on or after November 18, 2004, and only as to wrap mortgages secured by property within the City of New York, mortgage tax will be due on both the amount of new money and the principal balance of the existing mortgage around which it wraps.

For example, a lender chooses to provide the borrower with a wrap mortgage in the full face amount of one-million dollars. An existing mortgage with an unpaid principal balance of six-hundred and fifty thousand dollars was previously recorded and is a lien on the same property. In the past, the new mortgage for one-million would be subject to mortgage tax only on the new money advanced which, in this case, is three-hundred fifty thousand dollars. Wrap mortgages encumbering property located outside the counties of the City of New York will be taxed only on the amount of the new money. In the case of a wrap mortgage on property in the City of New York, our one-million dollar Wrap mortgage will be taxed at the rate of 2% (for residential, commercial property or vacant land under \$500,000), 2.125% (for residential property for \$500,000 or more) or 2.75% (for commercial property or vacant land for \$500,000 or more).

In an economic environment of rising interest rates, a climate exists

¹ The language of the section is inconsistent with the actual relationship of the players in a wrap mortgage situation and needs correction. The wrap mortgagee's equity in its mortgage increases as payments of principal are remitted by it to the underlying senior mortgagee. In respect to the senior mortgagee, its equity interest in its lien on the mortgaged property is reduced and is added to the wrap mortgagee's lien. The senior mortgagee has no privity with, nor any direct interest in the subordinate wrap mortgage. What this section appears to be describing is the reduction of the senior mortgagee's lien as a result of payments remitted on account of the senior lien by the junior wraparound mortgagee whose lien then is increased up to the face amount of the wrap mortgage.

² See *First Fiscal Fund Corp v. State Tax Commission*, 49 A.D.2d 408, 375 N.Y.S.2d 433 (App Div 3rd 1975), aff'd 40N.Y.2d 940, 390 N.Y.2d 412 (1976). At page 434, the Court wrote "[s]ections 253 and 253-a of the Tax Law impose a tax upon the 'principal debt or obligation' secured by a mortgage on real property. In the present case, it is clear that of the total indebtedness secured by the third [wraparound] mortgage only \$1,095,000 constitutes new indebtedness, while the remaining \$1,605,000 constitutes old indebtedness upon which mortgage recording tax already has been paid."

favoring use of the wrap mortgage financing technique. I would suspect that the City is aware of this potential and is seeking to cash in. When a borrower wants to refinance existing, low-cost debt or where a seller is taking back a purchase money mortgage (and assuming that there is no issue with a due on sale clause), the wrap mortgage offers an attractive option for both lenders and borrowers. The lender is able to offer the borrower a more competitive interest rate because the lender earns an interest return on the face amount of the mortgage loan while servicing the existing debt at its lower interest rate. Rather than lending the full amount of the required borrowing, the new lender goes out of pocket only to the extent of the new money portion of the financing. This lender is, in effect, *borrowing the remaining portion of the loan from the existing mortgage lender simply by not retiring that senior debt.* The wrap mortgage lender's security is protected since the lender receives the full amount of the new mortgage payment and remits to the low rate existing lender, the payment applicable to that portion of the debt. Moreover, the principal amount of the loan advanced by the wrap mortgage lender increases as it reduces the principal balance of the existing mortgage thereby ensuring that the wrap Lender remains fully secured. To summarize, the wrap mortgage is a *mutually beneficial situation* both for the borrower and the lender.

b. Spreader or Additional (Collateral Security) Mortgages:

The second type of mortgage transaction affected by this Chapter is the practice of spreading mortgages; usually to give an existing lender additional collateral security; to move mortgages from one property to another, both owned by the same or related borrowers or from the property owned by one borrower to property owned by another unrelated entity with the result that the existing mortgage debt can be used to reduce the mortgage tax on subsequent mortgage financing.

This portion of Chap. 60 similarly applies only to instruments recorded on or after November 18, 2004, affecting properties in the City of New York. While the drafters have crafted the prohibition so that New York City borrowers owning multiple properties in the same named entity are mostly unaffected, the amendment to § 250 will close the door on many new transactions.

In this regard, the bill amends § 255(1)(a)(i) to add a new paragraph (ii). Section 255 allows for the recording of "Supplemental" mortgage documents, *so long as the document does not create any new or greater indebtedness.* Before the change in the law, documents such as mortgage modification, extension, consolidation or spreader agreements that merely modify the terms or add additional property to secure an existing mortgage loan was not subject to additional mortgage tax. This section also allowed the recording of new mortgages given solely as additional security for an existing debt, irrespective of the identity of the property owner. Prior to the adoption of Chapter 60, additional mortgage tax would not become due under any of these types of instruments *except where the principal amount secured by the underlying mortgage was increased, i.e., an additional loan of new money is made and consolidated with the original debt and spread to other property, or where unpaid and accrued interest is capitalized as principal debt.*

In the context of a spreader agreement, a lender may have required a mortgage on additional property from a borrower to enhance the

lender's security position, i.e., as a condition for some modification of the loan terms. The spreader agreement adding new property would be deemed a supplemental mortgage instrument under § 255 and exempt from additional tax *provided no new money was being secured.* Current interpretations of the tax law would even allow the lender to subsequently release the original property from the lien of the spread mortgage without the imposition of additional mortgage tax. Assuming the cooperation of the lender, this device would allow owners of multiple properties the luxury of moving their mortgage debt from property to property to maximize the equity value of individual properties. Also covered by the amendment is the common practice of lenders who take mortgages beyond the primary mortgage on other properties owned by a borrower (i.e., a residence) as additional security where for a debt owed by a business entity.

Under the provisions of Chapter 60, Part Q, however, this practice, as applied to spreader agreements or additional mortgages on property in the City of New York, is *now sharply restricted.*

To effect this change, the language of § 255 was amended by Chap. 60 by adding a new subparagraph (ii), as follows –

§ 255. Supplemental Mortgages

1.(a)(i) . . .

(ii). Notwithstanding any provision to the contrary in subparagraph (1) of this paragraph, the taxes imposed by or pursuant to the authority of this article shall apply to the recording of a spreading agreement or additional mortgage which imposes the lien thereof upon real property located in any city in the state having a population of one million or more and not originally covered by or described in a recorded primary mortgage, unless the real property that becomes subject to the lien of such spreading agreement or additional mortgage is owned by the mortgagor of the real property subject to the lien of such recorded primary mortgage. If the commissioner of taxation and finance finds that transfers of one or both of such properties in connection with the recording of the spreading agreement or additional mortgage have been undertaken for the purpose of avoiding or evading the application of this paragraph rather than solely for an independent business or financial purpose, such commissioner may disregard such transfers. For purposes of this subparagraph, there shall be a presumption that all transfers of one or both of such properties to related parties within the twelve-month period preceding the recording of such spreading agreement or additional mortgage have been undertaken for tax avoidance or evasion purposes and such presumption may be rebutted only with clear and convincing evidence to the contrary. For this purpose, the term "related" shall have the same meaning as in paragraph (b) of subdivision two of section two hundred fifty-three-a of this article except that references to "fifty percent" in such paragraph (b) shall be read as "twenty-five percent". (Emphasis added)

New subparagraph 2, empowers the Commissioner of Finance to

"disregard" all transfers of property, even presumably to the same entity that is the borrower under the underlying mortgage, if such transfer was found by the Commissioner, to have been ". . . undertaken for the purpose of avoiding or evading the application of this paragraph rather than solely for an independent business or financial purpose" In addition, the Law imposes a presumption that all transfers of title to a "related" party, as the term is defined in § 253-a, as modified, within the preceding twelve months were made for "tax avoidance or evasion purposes".

The definition of the term "related" found in § 255(1)(a)(ii) is borrowed from § 253-a(2)(b), but for the purposes of amending § 255, the threshold at which an interest in an entity is deemed related is reduced from "fifty percent" to "twenty-five percent."³

§ 253-a. Recording tax by a city of one million or more

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(b) The term "related", when used in this subdivision with reference to mortgagors, shall include, but shall not be limited to, the following relationships:

(i) members of a family, including spouses, ancestors, lineal descendants, and brothers and sisters (whether by the whole or half blood);

(ii) a shareholder and a corporation more than fifty percent of the value of the outstanding stock of which is owned or controlled directly or indirectly by such shareholder;

(iii) a partner and a partnership more than fifty percent of the capital or profits interest in which is owned or controlled directly or indirectly by such partner;

(iv) a beneficiary and a trust more than fifty percent of the beneficial interest in which is owned or controlled directly or indirectly by such beneficiary;

(v) 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

(vi) a grantor of a trust and such trust.

In respect to properties within the City of New York, this Chapter effectively precludes spreading or otherwise transferring mortgages, or the adding of additional mortgages to properties owned by any entity, *other than the mortgagor under the existing underlying mortgage*. It will most certainly chill the use of the spreader or additional security mortgage where it would impose a new lien on property in the City of New York. A reading of the added language

to subparagraph § 255 suggests that even a transfer of title to the same entity that is the named borrower in the original mortgage, whether within the preceding twelve months or not, *could be disregarded and be deemed a transfer to avoid or evade the mortgage tax*. We must await regulations and rulings by the Department to see just how narrowly, or broadly, it interprets the powers to disregard transfers granted under the new provision.

To determine if a spreader or additional mortgage is subject to the assessment of mortgage tax under the amended § 255, we do not look at the original underlying mortgage obligation and instruments but rather to whether the subsequent spreader agreement or additional mortgage instrument imposes a lien on property in the City of New York that was not covered by the original mortgage agreement.

" . . . the taxes imposed by or pursuant to the authority of this article shall apply to the recording of a spreading agreement or additional mortgage which imposes the lien thereof upon real property located in any city in the state having a population of one million or more and not originally covered by or described in a recorded primary mortgage, . . . " (Emphasis added)

Where the original mortgage encumbers property located outside the City of New York and is spread to property within the City, or such NYC property is to become the subject of an additional collateral security mortgage, *such instrument will attract mortgage tax, unless perhaps the property is owned by the same entity that is the mortgagor under the underlying mortgage*. However, the converse is not true. Where the primary mortgage encumbers property located within the City of New York and that mortgage is being spread to, or an additional collateral security mortgage is being given on property located *outside the City of New York, no additional mortgage tax will become due on the spreader or additional mortgage since the spreader or additional mortgage does not create a new lien on property within the City*.

Examples of the typical types of spreader or additional mortgage transactions affected by this amendment are –

- **The guaranty of related entity's obligations by principal under a collateral security mortgage:** A business owner or owner of 25% or more of the shares in a related entity is required to grant, as additional collateral security for an existing or contemporaneously granted mortgage loan on the business property, a mortgage on a property personally owned, i.e., a residence located within the City of New York. Mortgage tax will be imposed on the collateral mortgage based on the principal amount of the underlying mortgage debt. If the principal's property on which the collateral security mortgage *is not* located within the City, notwithstanding that the underlying mortgage encumbers property in New York City, no mortgage tax will be imposed on the additional mortgage instrument.
- **Spreading mortgage financing to subsequently acquired property of original borrower:** This would include situations where a developer of a site acquires parcels in series separately from other properties and spreads the acquisition financing over the various parcels as they are acquired. The developer may

³ Section 2 of part H of Chap. 60 amends 255(1)(a) to add a new subparagraph (II) that reads, in part, "[f]or this purpose, the term "related" shall have the same meaning as in paragraph (b) of subdivision two of section two hundred fifty-three-a of this article *except that references to "fifty percent" in such paragraph (b) shall be read as "twenty-five percent"*. (Emphasis added)

want to spread the mortgages over all of its properties and use the mortgages as spread as parts of its consolidated construction loan financing. To the extent that this type of transaction could be entitled to an exemption from tax under the "independent business or financial purpose", based on a showing of "clear and convincing evidence", is an open question at this time.

- **Lender seeks to include all property owned by borrower in its mortgage as security:** The lender has made a loan secured by a mortgage. The lender now requires that the borrower spread that mortgage to encumber other properties owned by the borrower. As to any property lying within the City of New York, no additional tax should be imposed on the spreader agreement if the added property is owned by the principal borrower. As to any property located outside the City of New York, whether owned by the principal borrower or by a related or unrelated entity or person, no additional tax will be imposed. A spreader agreement creating a lien on property within the City, not owned by the principal borrower, but owned by a related person or entity or any other person or entity, tax will be imposed based on the amount of the principal underlying mortgage debt.

II. ARTICLE 22 PERSONAL INCOME TAX (PART H)

Nonresident Sales of Coops, Prepayment of Tax on Gains:

Part H of Chap. 60 amends Tax Law Article 22, §§ 631 & 663, which relates to personal income tax on nonresident and part time residents (including nonresident estates and trusts), to include as taxable income the gain derived from the sale of the shares of stock in a cooperative apartment corporation.

Beginning with the taxable year, January 1, 2004, this Chapter also amends § 663 to require that such nonresident individual, estate or trust pay the estimated tax on the gain as such taxpayers must now do for sales of real property. In 2003 the legislature enacted Tax Law § 663 (added by L 2003, ch 62), which imposed on nonresident individuals and on nonresident estates and trusts the obligation to file estimated returns and pay the estimated tax, if any, due on the gain derived from the sale of NY real property. The difference in the current amendment to § 663 is that the filing and payment obligation on sales of coop shares is not a condition precedent to perfecting the transfer as it is with the sale of real property, since there is no public recording of coop apartment sales.

Section 5, of the Bill amends § 663 to add a new subsection (i) contain Part H of Chap. 60 that imposes the obligation to file the estimated return and make a payment, if any, within fifteen days after the transfer reads as follows –

(i) the estimated personal income tax liability on the gain, if any, from the sale, conveyance or other disposition of shares of stock in a cooperative housing corporation shall be paid to the commissioner no later than the fifteenth day after the delivery of the instrument affecting such

sale, conveyance or other disposition. For purposes of this section, the date of the instrument affecting such sale, conveyance or other disposition shall be presumed to be the date of delivery of such instrument. (Emphasis added).

In public notice circulated on September 13, the Department of Taxation and Finance has stated (see Notice #–04-15 September 2004), that the estimated tax payment will be made on its Form No. IT-2664 (Nonresident Cooperative Unit Estimated Income Tax Payment Form). The form, together with a TSM-M (Technical Services Bureau Memorandum) containing detailed information will be released prior to November 18.

In respect to Nonresident taxpayers who sold in 2004 prior to November 18, the Notice contains the following advice –

“ . . . nonresidents who sold or transferred shares in 2004 prior to November 18, or who are exempt from the 15-day estimated income tax payment rule for sales or transfers on or after November 18, will not have paid this estimated income tax. Accordingly, to take into account the increase in their New York personal income tax attributable to the inclusion of the gain in their New York source income, these taxpayers may have to adjust their September 15, 2004, or January 15, 2005, estimated income tax payments, or may have to begin making estimated income tax payments on September 15 or January 15. For information on how to amend your estimated income tax payments or to begin making estimated income tax payments, see Form IT-2105-I, Instructions for Form IT-2105.”

We will continue to monitor these developments and publish additional updates as needed.



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is a publication of
Fidelity National Title Insurance Company

