Milbank

Insights

Real Estate

Proposed New York Mortgage Recording Tax on Mezzanine Loans and Preferred Equity Financing Threatens to Increase Borrowing Costs in New York

March 6, 2023

Contact

Erwin Dweck, Partner
+1 212.530.5255
edweck@milbank.com

Kevin O'Shea, Partner
+1 212.530.5254
koshea@milbank.com

Yaakov Sheinfeld, Partner
+1 212.530.5274
ysheinfeld@milbank.com

Jonathan M. Karl, Partner
+1 212.530.5337
jkarl@milbank.com

Christina Wing, Associate
+1 212.530.5304
cwing@milbank.com

Shannon Mis-Marzano, Associate
+1 212.530.5692
smis@milbank.com

Emily Southwick*, Associate
+1 212.530.5733
esouthwick@milbank.com
**not yet admitted to practice in NY*

New York State Senators have proposed Bill S-318, which would, if adopted, levy a "mortgage recording tax" on mezzanine debt and preferred equity investments. This bill resurrects earlier failed legislative efforts to pass virtually identical bills in 2020 and 2021. Supporters of the bill claim that mezzanine debt and preferred equity investments are used for the same purpose as traditional mortgage financing without the same transparency and tax revenue for the state, and that the additional tax revenue would help close the funding gaps for affordable and low-income housing in New York.

Specifically, the proposed legislation would:

1. Require mezzanine lenders and preferred equity investors to file a UCC-1 financing statement with the New York State Secretary of State to perfect their security interests in the mezzanine debt and/or preferred equity investment "related to the real property upon which the mortgage instrument is filed"; and
2. Impose a state-level recording tax, similar to the current mortgage recording tax, upon the filing of such a financing statement. Cities and counties would also be authorized to impose local recording taxes in addition to the state-level tax.

Mezzanine lenders and preferred equity investors would be precluded from enforcing remedies (i.e., exercising a mezzanine loan foreclosure or control-shift remedies) unless they had filed and paid the tax. Perfection of a security interest for mezzanine debt could only be accomplished through the filing of financing statements, which would put New York at odds with other states, where control via possession of a certificated interest is not only sufficient but is a superior method of perfection as compared to the filing of a financing statement. The bill furthermore does not specify how these perfection requirements would work in multi-property transactions across multiple jurisdictions and where pledges of equity in New York real estate otherwise indirectly secures corporate credit facilities. Given that Delaware is the primary

jurisdiction in which commercial real estate entities are formed and that UCC filings must be made in the state of formation, this bill leaves many questions unanswered as to how that critical fact will be addressed – surely New York cannot assess a tax on Delaware filings. Additionally, New York is the governing law for many real estate transactions that secured real estate wholly outside of the State – would enforcement of such a pledge now also require a tax be paid to New York?

The uncertainty created by the bill extends beyond its perfection requirements. The concerns surrounding the definitions of mezzanine debt and preferred equity investments from the 2020 and 2021 bills still remain. The definitions are overly broad and, as currently written, could be interpreted to capture any mezzanine debt and preferred equity investments secured by entities that indirectly own property. This lack of clarity would have a chilling impact beyond the commercial real estate market, deterring investment in companies that own or ground lease real property in New York.

In addition, while the bill does not extend to pre-enactment transactions, questions remain as to whether the creation of a new mezzanine loan pursuant to the common secondary market provisions found in many existing loan agreements, or the filing of UCC-3 continuation statements for pre-enactment transactions, would trigger the tax.

The bill is more likely to disincentivize secured financing activity, potentially resulting in unintended consequences. Mezzanine debt and preferred equity financings would become more expensive, adding up to an additional 2.8% cost to transactions. In our current interest rate environment, this places a higher burden on real estate investors, who would be incentivized to invest in more tax-friendly jurisdictions to generate required returns. In any event, these higher costs will likely be passed on to borrowers, and then to their tenants, and then to the consumer.

While many are focusing on the failures of the past proposals in 2020 and 2021 as a sign that the current bill is unlikely to pass, the previous concerns precipitated by COVID-19 have dissipated and the need for tax revenue is dire given the current economic situation. The motivation behind support for the bill, however, is misguided given the current nature of New York mortgage recording taxes which, consistent with common practice in commercial transactions, are only paid on any "excess" debt provided over existing debt such that the proposed tax would create only a "one-time" assist to the budget and be unlikely to yield the recurring income sought by the proponents of the bill. Additionally, investors and practitioners will be certain to devise other means of addressing this situation. For example, given that most entities are formed in Delaware, perhaps governing law provisions of pledge agreements will simply shift to Delaware law and Delaware courts. The questions are many…

Real Estate Group Contacts

New York | 55 Hudson Yards, New York, NY 10001-2163

Erwin Dweck	edweck@milbank.com	+1 212.530.5255
Kevin O'Shea	koshea@milbank.com	+1 212.530.5254
Yaakov Sheinfeld	ysheinfeld@milbank.com	+1 212.530.5274
Jonathan M. Karl	jkarl@milbank.com	+1 212.530.5337
Christina Wing	cwing@milbank.com	+1 212.530.5304

Shannon Mis-Marzano	smis@milbank.com	+1 212.530.5692
Emily Southwick	esouthwick@milbank.com	+1 212.530.5733

Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any member of our Real Estate group.

This Client Alert is a source of general information for clients and friends of Milbank LLP. Its content should not be construed as legal advice, and readers should not act upon the information in this Client Alert without consulting counsel.

© 2023 Milbank LLP
All rights reserved. Attorney Advertising. Prior results do not guarantee a similar outcome.