GT GreenbergTraurig

Alert | Tax/Real Estate

March 2021

New York's Proposed Tax on Mezzanine Debt, Preferred Equity May Have Adverse Implications for NY Lenders, Borrowers

Legislation has been reintroduced in the New York State Assembly (A.3009-B Part VV) and the Senate (S.2509-B Part SS) that, if enacted, will require (i) the recording of certain mezzanine debt and preferred equity investments and (ii) the payment of mortgage recording tax (MRT) on such debt or investments. The stated purpose of the legislation is to provide revenue for public and affordable housing. While it is unclear whether the legislation will be enacted, New York lenders and borrowers should be aware of the potential adverse implications.

The proposal expands the scope of Section 291-k of the New York State Real Property Law and makes conforming changes, as described below, to Section 250 of the New York State Tax Law and Section 9-601 of the New York State's Uniform Commercial Code. At the outset, the proposed legislation provides that "whenever a mortgage instrument is recorded in the office of the recording officer of any county, any mezzanine debt or preferred equity investment related to the real property upon which the mortgage instrument is filed shall also be recorded with such mortgage instrument."

The proposal defines mezzanine debt and preferred equity investments as:

> debt carried by a borrower that may be subordinate to the primary lien and is senior to the common shares of an entity or the borrower's equity and reported as assets for the purposes of

© 2021 Greenberg Traurig, LLP

financing such primary lien. This shall include non-traditional financing techniques such as a direct or indirect investment by a financing source in an entity that owns the equity interests of the underlying mortgage where the financing source has special rights or preferred rights such as: (i) the right to receive a special or preferred rate of return on its capital investment; and (ii) the right to an accelerated repayment of the investors capital contribution.

In addition to amending the Real Property Law, the proposed legislation also amends New York State's Uniform Commercial Code (UCC) by adding a new subdivision to section 9-601 to provide that "a security interest in mezzanine debt and/or preferred equity investments related to the real property upon which a mortgage instrument is filed, may only be perfected by the filing of a financing statement under subpart 1 of part 5 of this article and only after the payment of any taxes due pursuant to section two hundred ninety-one-k of the real property law."

Finally, the proposed legislation amends the New York Tax Law to make clear that "mezzanine debt and preferred equity investments" are taxable, and that the tax will be measured by the amount of "principal debtor obligations" which may be secured by a security agreement "in relation to real property upon which a mortgage instrument is filed." This means that, if the legislation is passed, mezzanine debt and preferred equity investments with respect to New York City commercial property with an amount or having a value of $500,000 or more would be taxed at the rate of 2.85%.

The proposed legislation is flawed for a number of reasons, including the following:

I. The proposed legislation is vague and misunderstands the purpose and nature of mezzanine debt.

Mezzanine debt has become an integral and common part of real estate finance and investment not primarily as a means to avoid MRT, but as a way of further leveraging an asset beyond first mortgage financing. A mezzanine borrower typically pledges the equity in the owner of property to the mezzanine lender as security for the loan. A UCC financing statement typically is filed concurrently with the closing. If the property owner raises capital in the form of preferred equity, there is no UCC filing.

The purpose and justification stated in the Sponsor's memorandum in support of the legislation erroneously states that mezzanine debt is used to finance real estate purchases. This is not generally true, as mezzanine debt is used in a wide variety of contexts, including in recapitalization transactions, construction, and rehabilitation. In practice real estate mezzanine debt is now used in a variety of contexts: for construction, development and rehabilitation, as bridge financing. These loans, which are secured by a pledge of the partnership or limited liability company interests, command a higher interest rate, since they are not secured by real property and represent a riskier position in a debt stack. Mezzanine debt provides flexibility needed for modern real estate financing. Mezzanine debt is typically used because a senior lender will not want to loan in excess of a certain loan to value with respect to the property or more than a certain loan to cost of a project. Investors looking for additional leverage would go to the mezzanine markets to find lenders that are willing to make loans in those riskier positions for additional yield.

It is unclear what 'mezzanine debt related to the property' means, and this language could inadvertently capture other forms of debt. For example, does an unsecured corporate level loan to an entity that owns real property encumbered by a recorded mortgage qualify as mezzanine debt? It is also unclear what the provision "and reported as assets for the purposes of financing such primary lien" is intended to mean or capture. Mezzanine debt is typically separate and distinct from any mortgage debt, held by a different lender, and has a different risk profile than mortgage loan debt.

© 2021 Greenberg Traurig, LLP

The vague and expansive definition of 'preferred equity' could subject investments that have no connection to the financing of real property to the MRT. For example, is a partner who provides services to a partnership that owns mortgaged real property required to record the partnership agreement and pay MRT on its investment? Similarly, what if a partnership agreement contains a provision for returning capital to an investor earlier than another or includes a carried interest provision? Could those investments be deemed 'preferred equity' if the partnership owns mortgaged property?

The proposed new subdivision to UCC section 9-601 also reflects a fundamental misunderstanding of preferred equity. Perfection, indeed all of UCC Article 9, applies to secured transactions. UCC financing statements are not filed in preferred equity transactions not because parties are seeking to avoid MRT, but because preferred equity transactions are not secured transactions and are created and exist outside of Article 9 of the UCC. In addition, the proposed legislation prohibits foreclosure on the mezzanine debt or preferred equity in New York courts unless the MRT has been paid. New York's legislation cannot prevent foreclosure in another jurisdiction if, as a result of the enactment of this legislation, the agreements entered into provide for foreclosure litigation to be commenced in another jurisdiction. Preferred equity is not enforced by foreclosure, which is a statutory remedy inapplicable to equity transactions. Preferred equity investments are not and cannot be remedied by foreclosure. Thus, in the case of both mezzanine debt and preferred equity the tax revenue that is projected to be generated by this proposal may never be realized.

II. The proposed legislation will increase the cost of owning, developing, and rehabilitating New York properties.

Investment in real estate, including raising debt to purchase, develop, and rehabilitate represents an enormous part of New York's economy. Adding a significant MRT unquestionably increases the costs for both for profit and not-for-profit owners and developers, since the MRT does not exempt nonprofit organizations from that tax. Limiting the use of mezzanine debt reduces the flexibility that property owners and developers need to finance projects and could make needed projects across a variety of sectors less economically viable.

Today's real estate market is dynamic and under stress; having maximum flexibility to finance real estate investment and development is essential. Borrowers need access to capital and the option of accessing multiple sources to assemble competitive and viable debt packages. This legislation will stymie development by limiting the availability of debt and increasing the cost of the debt that remains available.

III. The proposed legislation violates the Constitution of the State of New York.

Article XVI Section 3 of the New York State Constitution states: "Intangible personal property shall not be taxed ad valorem, nor shall any excise tax be levied solely because of the ownership or possession thereof, except that the income therefrom may be taken into consideration in computing any excise tax measured by income generally."

The purpose of this provision in the Constitution is to assure nonresidents of New York who have bank deposits (debts owed to depositors by the bank) and those whose stock certificates were held in New York brokerages that they would not face a state or local tax on those intangibles. New York does not and cannot impose a tax on a mortgage note (or the mortgage document) but, rather imposes the MRT, which is an excise tax on the privilege of recording a mortgage.

© 2021 Greenberg Traurig, LLP

In *Franklin Soc. for Home Building & Savings v. Bennett, et al.*, 282 NY 79, (12/28/1939), the Court of Appeals stated that the "validity of the tax depends upon whether it is properly labelled or classified as a 'recording tax,' which is not levied solely because of the ownership or possession of a mortgage or, is, as the plaintiff maintains, an ad valorem tax on property, within the meaning of the constitutional provision." The Court held the MRT was "a tax payable only when a mortgage is recorded to obtain the benefit of the recording acts or to rid the mortgage or its owner from the penalties and drastic restrictions resulting from failure to record."

This proposed legislation **requires** mezzanine debt and preferred equity investments to be recorded so that the MRT can be imposed. In addition, the recording of a note reflecting mezzanine debt provides none of the benefits that are afforded a recorded mortgage. Mandating the recording of a document reflecting an intangible asset in order to impose the MRT turns the excise tax on the privilege of recording into an unconstitutional tax on an intangible asset.

Authors

This GT Alert was prepared by:

- Glenn Newman | +1 212.801.3190 | newmang@gtlaw.com
- Stephen L. Rabinowitz | +1 212.801.9295 | rabinowitzs@gtlaw.com
- Kristen J. Lonergan | +1 212.801.6927 | lonergank@gtlaw.com
- Howard S. Schochet | +1 212.801.6833 | schocheth@gtlaw.com
- Ivy J. Lapides | +1 212.801.9208 | lapidesi@gtlaw.com

Albany. Amsterdam. Atlanta. Austin. Boston. Chicago. Dallas. Delaware. Denver. Fort Lauderdale. Germany.¬ Houston. Las Vegas. London.* Los Angeles. Mexico City.+ Miami. Milan.» Minneapolis. New Jersey. New York. Northern Virginia. Orange County. Orlando. Philadelphia. Phoenix. Sacramento. Salt Lake City. San Francisco. Seoul.∞ Shanghai. Silicon Valley. Tallahassee. Tampa. Tel Aviv.^ Tokyo.¤ Warsaw.~ Washington, D.C.. West Palm Beach. Westchester County.

*This Greenberg Traurig Alert is issued for informational purposes only and is not intended to be construed or used as general legal advice nor as a solicitation of any type. Please contact the author(s) or your Greenberg Traurig contact if you have questions regarding the currency of this information. The hiring of a lawyer is an important decision. Before you decide, ask for written information about the lawyer's legal qualifications and experience. Greenberg Traurig is a service mark and trade name of Greenberg Traurig, LLP and Greenberg Traurig, P.A. ¬Greenberg Traurig's Berlin office is operated by Greenberg Traurig Germany, an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. *Operates as a separate UK registered legal entity. +Greenberg Traurig's Mexico City office is operated by Greenberg Traurig, S.C., an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. »Greenberg Traurig's Milan office is operated by Greenberg Traurig Santa Maria, an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ∞Operates as Greenberg Traurig LLP Foreign Legal Consultant Office. ^Greenberg Traurig's Tel Aviv office is a branch of Greenberg Traurig, P.A., Florida, USA. ¤Greenberg Traurig's Tokyo Office is operated by GT Tokyo Horitsu Jimusho and Greenberg Traurig Gaikokuhojimubengoshi Jimusho, affiliates of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ~Greenberg Traurig's Warsaw office is operated by Greenberg Traurig Grzesiak sp.k., an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. Certain partners in Greenberg Traurig Grzesiak sp.k. are also shareholders in Greenberg Traurig, P.A. Images in this advertisement do not depict Greenberg Traurig attorneys, clients, staff or facilities. No aspect of this advertisement has been approved by the Supreme Court of New Jersey. ©2021 Greenberg Traurig, LLP. All rights reserved.*