

# APPLYING THE CONTINUING LIEN EXCLUSION TO CONSIDERATION

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The closing of the sellers' residence has been completed. All papers necessary to transfer title have been signed and delivered and funds have passed. Mortgage tax payable by the purchasers was reduced by their counsel arranging to have the existing mortgage survive the transfer and be assigned to their new lender. The sellers' transfer tax obligations were also reduced by reason of the outstanding principal amount of that mortgage being deducted from consideration to arrive at the amount of taxable consideration for computing the New York City Real Property Transfer Tax ("RPTT")<sup>1</sup> and the New York State Real Estate Transfer Tax ("RETT")<sup>2</sup>. Everyone left the closing satisfied that it was a deal well done.

Months later, however, the taxing authority, most likely the City of New York's Department of Finance, issues a notice to the sellers claiming a deficiency in the amount of the transfer tax paid in connection with the closing. The Department's position is that the continuing lien deduction, in the amount of the pre-existing mortgage debt, was improperly applied. Although the action which caused the City to disallow the deduction is alleged to have taken place after the closing and was outside the sellers' control, the City seeks from the sellers an additional amount of transfer tax from the sellers, as well as interest and penalties on the claimed underpayment.

It was once common practice in New York for a transfer of residential real property to be made subject to the lien of a pre-existing mortgage. The transferee might take advantage of a favorable interest rate on the existing loan, or mortgage tax savings on the prior mortgage as assigned to a purchaser's lender was sufficiently attractive to offset additional closing costs incurred to complete the assignment and restate the lien. Although the enforcement of due on sale or transfer clauses in residential mortgages has largely stemmed this practice, there are still instances in which the parties to a conveyance may wish to take title subject to the lien of an existing mortgage and may do so with the indulgence of the lenders involved.

The parties to a conveyance may intend to transfer title subject to a mortgage when the transfer is between spouses pursuant to a separation agreement or a decree of marital dissolution. Transferring title subject to a mortgage may also happen when a transfer is made to family members for the purpose of estate planning or to insulate a home from the reach of possible

future creditors. Lenders in New York may be less likely to insist that due on sale or transfer provisions be enforced where title remains in the immediate family of the mortgagor and there is no change in the occupancy of the premises.<sup>3</sup>

Regardless of the reason in a given situation for conveying "subject to", and putting aside the possible mortgage tax savings achieved in maintaining a mortgage on which recording tax was previously paid, there are transfer tax savings to be achieved when title in certain instances is taken with an existing mortgage surviving the transfer.

It should be noted for analyzing application of transfer taxes that even on a gift transfer, the unpaid balance of a pre-existing mortgage that remains on the property after a closing and is not discharged in connection with the closing is considered by the taxing authorities to be consideration and taxable absent an exclusion under law.<sup>4</sup>

At the hypothetical closing above, mortgage tax was not required to be paid anew on the principal balance remaining at the date of transfer. If the existing mortgage was assigned to a purchaser's lender, the new borrower would affirm under Real Property Law Section 275 that the debt remained bona fide and the assignee was not a nominee of the owner of the property.<sup>5</sup> Note that under Tax Law Section 253-b a "credit line mortgage" on a one-to-six family owner occupied residence may not be assumed without the payment of mortgage tax on the transfer of title of the mortgaged property to a person or persons not related by blood, marriage or adoption to the original obligor.

For the RETT, under Tax Law Section 1402(a) the amount of remaining liens or encumbrances may be excluded in the computation of taxable consideration on the transfer of a one-to-three family residence or an individual condominium unit, or interest therein, or on another conveyance when the amount of consideration, inclusive of the unpaid principal balance of pre-existing, surviving mortgage liens, is less than \$500,000.<sup>6</sup>

For transfers occurring on and after August 28, 1997, a continuing lien deduction was made available for the RPTT by enactment of Chapter 314 of the Laws of 1997 which amended Tax Law Section 1201 ("Taxes administered by cities of one million or more"). The outstanding amount of a lien existing prior to a transfer and continuing after the transfer may under Chapter 314 be excluded from consideration for the RPTT when the property being transferred is a one-to-three family house, a residential cooperative or condominium unit, or an economic interest in such property. The exclusion from consideration is not allowed on a transfer to a mortgagee by either a referee's deed or a deed in lieu of foreclosure, or on a transfer to a Real Estate Investment Trust.

Chapter 314 also provides that the exclusion is not available for a mortgage, lien or encumbrance "placed on the property or interest in connection with, or in anticipation of, the conveyance or transfer, or by reason of deferred payments of the purchase price whether represented by notes or otherwise". (Emphasis added)

A continuing lien deduction had previously been allowed in computing taxable consideration under the RPTT. For transfers made on or before July 1, 1971, the rate of tax was one-half of one

percent of net consideration after the deduction of the indebtedness outstanding under surviving mortgage liens. For transfers made on or after July 1, 1971 and before February 1, 1982, the rate of tax was one percent of net consideration. In both cases, consideration net of pre-existing liens was determined without regard to the type of property being transacted.

A 1982 amendment<sup>7</sup> to Tax Law Section 1201 increased the transfer tax rate for commercial transactions to two percent of consideration and phased out the RPTT's continuing lien deduction. For conveyances made on and after February 1, 1982 and before July 1, 1982, the transfer tax was one percent of net consideration on the conveyance of a one-to-three family house or an individual residential condominium unit regardless of the amount of the consideration and on the conveyance of other types of property when the consideration was less than \$500,000. For other conveyances made between February 1, 1982 and July 1, 1982, the portion of the consideration attributable to the pre-existing lien was taxed at one percent; the balance of the consideration was taxed at the new two percent rate.

Therefore, from July 1, 1982 to August 28, 1997, the only transfer tax deduction for a continuing lien for property in New York City was the state's exclusion from consideration for the RETT.

Historically, the City's Department of Finance has narrowly applied the continuing lien exclusion from consideration. The Department in 1981, for example, informally indicated that it would not allow the outstanding principal amount of a pre-existing mortgage to be deducted from consideration when it was assigned to the grantee's new lender and consolidated with an additional mortgage.<sup>8</sup> It also held in a July 1979 Bulletin that a severed, substitute mortgage would not on the first sale of a condominium unit be deducted in determining taxable net consideration.

In *Exchange Plaza Partners v. City of New York*<sup>9</sup>, the Appellate Division, First Department, upheld the City's position that the amount of construction loan mortgages taken subject to by the transferee at a closing in February 1983 pursuant to a contract of sale entered into in 1981 should not have been deducted to arrive at the amount of taxable consideration. It agreed with the City that execution by the transferee and the mortgage assignee the day after the closing of title of a Note Modification Agreement which changed the loan term and interest rate resulted in a new loan and was not a continuation of the prior mortgage obligations for the RPTT.

In the Matter of *Cord Meyer Development Company*<sup>10</sup>, an Opinion of an Administrative Law Judge of the New York City Tax Appeals Tribunal issued January 9, 1992, relating to a transfer in 1984 pursuant to a contract of sale entered into in 1981, held that a mortgage assigned to the transferee cooperative corporation's lender was not an excludible lien. The mortgage in question was modified and extended, the interest rate was increased, and the balloon payment due date was extended to a later date. According to the Administrative Law Judge, "...the issue revolves around the changes to the obligation, effected in anticipation of, or in connection with, the transfer. If these changes create a new obligation, then the resulting lien may be said to be placed on the property in connection with the sale and so is includible in net consideration". It was held that such "material alteration" of the mortgage precluded its being characterized for the RPTT as a pre-existing lien.

Similarly, in 1983 the Appellate Division, Third Department, in *Matter of Defreal Holding Corp. v. City of New York*<sup>11</sup>, affirmed without opinion a lower court decision upholding the City's position that a mortgage executed five days prior to closing to enable the seller to pay outstanding real estate taxes was not properly deducted from consideration for the RPTT since it was a lien placed on the property in connection with the sale.<sup>12</sup>

A continuing lien deduction for the RPTT, however, again became effective, as noted above, on August 28, 1997. Approximately two years later, on August 6, 1999, the City's Department of Finance published in the City Record an amendment to Section 23-03 of Title 19 of the Rules of the City of New York Relating to the Real Property Transfer Tax ("RCNY") adding a new subdivision (k) captioned "Excludible Liens"(hereafter referred to as the "Regulation"). The Basis and Purposes of Amendments accompanying the Notice of Rulemaking sets forth the City's position on how it will apply the new rules and cautions that "(t)hese amendments reflect court decisions under the comparable provisions of the rules that applied to transfers prior to February 1, 1982". In light of the foregoing, it is reasonable to anticipate that the City's Department of Finance will again narrowly apply the continuing lien exclusion from consideration. Even so, the scope of the new rules is surprising.

Under the Regulation, acts of a seller prior to closing can impact whether the continuing lien exclusion from consideration will be recognized at all or limited by the Department of Finance. Post-closing acts of a purchaser may also retroactively render the taking of the exclusion at closing a nullity. In either case, there may be additional taxes imposed for the underpayment of tax for which the seller and the purchaser have joint and several liability.<sup>13</sup>

The Regulation sets forth broad parameters for identifying situations in which a mortgage, lien or other encumbrance (hereafter collectively referred to as a "mortgage") may not be treated as an "Excludible Lien" for computation of the RPTT. As in the statute, the Regulation statute provides that a mortgage cannot be excluded from consideration if it was "placed on the property or interest in connection with, or in anticipation of, the conveyance or transfer or by reason of deferred payments of the purchase price whether represented by notes or otherwise."

First, the Regulation provides, in accordance with the statute, that a mortgage originally placed on the property in connection with, or in anticipation of, a transfer may not be excluded from consideration. It further states that an increase in the amount of a mortgage in connection with, or in anticipation of, a transfer will not be an Excludible Lien to the extent of the increase.

The Department, in applying these two provisions, will look to see if the documents relating to the transaction indicate that the mortgage was executed prior to the closing was part of a plan to eventually transfer the property. It will be presumed that a mortgage placed on the property within six months prior to a transfer was in connection with, or in anticipation of, the transfer,<sup>14</sup> and the mortgage will not, therefore, be an Excludible Lien. The burden of proving otherwise is on the taxpayer.

It is possible, based on an illustration in the Regulation, that a mortgage first executed or increased in principal amount more than six months prior to a transfer will be included in consideration (and thus not be an Excludible Lien) on a finding that the lien was executed in

connection with or in anticipation of the transfer. The illustration sets forth an example in which a mortgage placed on the property six years prior to the transfer could be deemed executed in anticipation of the transfer.

Second, a mortgage which is satisfied or released, or merely reduced in principal amount but not discharged, after the closing will be deemed discharged or reduced in amount in connection with the transfer, and the exclusion from consideration will be disallowed or reduced accordingly if the documents relating to the transaction indicate that the discharge or reduction took place in connection with the transfer. There is effectively a presumption that the discharge or reduction of a mortgage within three months of the transfer is in connection with the transfer. The burden of proving otherwise is on the taxpayer.

Third, an existing mortgage the terms of which are materially altered in connection with, or in anticipation of, a transfer will be, in effect, presumed not be an Excludible Lien. A mortgage will be considered materially altered if within six months prior to or within three months after the transfer the identity of the holder of the mortgage has changed and there has been a change of ten percent or more in the interest rate or in the remaining repayment term. There appears to be a safe harbor for mortgages as to which such changes are made more than six months prior to or more than three months after the transfer.

An increase or a decrease in the principal amount of a mortgage will not be deemed a material alteration. Gift transfers and conveyances pursuant to a divorce decree or separation agreement are not subject to the material alteration rules.

Note also that the Regulation applies to the allocable portion of the mortgage on the property of a cooperative corporation which is included in the original transfer of shares by the cooperative corporation or the sponsor.

Illustrations set forth in the Regulation as examples of its application include the following:

A house is sold subject to a mortgage with a remaining principal balance of \$250,000, an interest rate of seven percent and a remaining term of ten years. This mortgage is assigned to the purchaser's lender and modified to have an interest rate of nine percent. There is no change in the loan term. Since there is a new mortgagee and as there has been an increase in the interest rate of more than ten percent (which constitutes a material alteration), the modification of the mortgage would be deemed to be made in connection with the transfer and the mortgage would not be an Excludible Lien for computing the RPTT.

Another example is a mortgage refinanced and increased in amount two months prior to a transfer of title. The increase in the loan amount would be deemed made in connection with, or in anticipation of, the transfer and the mortgage would not be an Excludible Lien to the extent of the increase.

It is imperative that real estate counsel representing sellers and purchasers of property to which the exclusion applies review the City's position as set forth in the Regulation when a continuing lien deduction under the RPTT is intended to be taken. It should be remembered in all instances,

as stated in the Regulation, that the taxpayer has the burden of proving that a lien or encumbrance qualifies as an excludible lien and of proving the amount that should be excluded.

Although the New York State Department of Taxation and Finance has not formally opined on whether it takes a position similar to that of the City of New York for the application of its continuing lien deduction, its Technical Services Bureau has at various times informally advised that it will look to see if either a mortgage was placed on the property in contemplation of a sale or whether the purchaser's intention at closing was to satisfy the surviving mortgage lien post-closing. The fact that, for example, a purchaser has an outstanding loan commitment at closing which is silent as to whether the lender will take an assignment of the existing lien may be deemed evidence of an intention to satisfy the surviving mortgage after the closing. If the intent is to satisfy the mortgage, the lien amount may not be excludible from consideration.

While counsel for both the transferor and transferee need to track the pre-closing history of an existing mortgage intended to survive closing to ensure that the lien will not be considered ineligible for transfer tax treatment as a continuing lien, a transferor's counsel should in the contract of sale also account for the possibility that the mortgage might be discharged or modified after the closing thereby resulting in the amount of transfer tax having been paid being challenged on audit by the taxing authorities.

This author has reviewed contracts of sale which deal with this post-closing concern. One way to account for this issue is for the contract to recite that the purchaser is not to satisfy, refinance or modify the mortgage in a manner that would cause the continuing lien exclusion taken to be invalidated by the taxing authority. More specifically, the contract might provide that if the surviving mortgage is assigned to a new lender and modified, neither the interest rate nor the term of the "new" loan will be changed by more than ten percent. Such a provision should be expressed as surviving the closing, and the transferee may appropriately be required to indemnify the transferor for any additional liability resulting from post-closing acts affecting the transfer tax treatment of the outstanding principal amount of the surviving mortgage lien.

This author has also become aware of a notice of a deficiency in transfer tax claimed by the City of New York which disallowed the exclusion from taxable consideration of an ostensibly excludible lien at a closing in April of 1999, which was prior to the date on which the Regulation was filed, prior to publication, with the City Clerk. The City's Department of Finance, as suggested in the Basis and Purpose of Amendments accompanying the Notice of Rulemaking for the Regulations referred to above, is proceeding on the basis that the Regulation is merely interpretive of existing law and can therefore be applied retroactively. This position may put in jeopardy parties who closed with a good faith reliance on the change in the City's transfer tax by Chapter 314 of the Laws of 1997.<sup>15</sup>

*Published in the New York Law Journal on February 14, 2001  
as "Applying the Continuing Lien Exclusion to Your Practice".*