

Spreader Agreements

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Part Q of Chapter 60 of the Laws of 2004 requires the payment of additional mortgage recording tax on the recording of spreader agreements and additional mortgages, and instruments refinancing wraparound mortgages, in New York City on and after Jan. 17, 2005.(1) The new law as initially enacted had an effective date of Nov. 18, but the effective date was extended by Chapter 745 of the Laws of 2004, signed into law on Dec. 17.(2)

The new law was included in the State's Budget Bill to deal with what New York City's Department of Finance (City Finance) and the New York State Department of Taxation and Finance (Department), believe are abusive practices. While it is clear from the text of the new law that wraparound mortgage refinancing and, in many instances, spreader agreements involving New York City property will require the payment of an additional mortgage recording tax, further understanding the new law and how to apply it requires clarification by the tax authorities.

In responding to this need, on Nov. 22 the Department's Technical Services Division issued Memorandum TSB-M-04(9)R, entitled "2004 Amendments to the Tax on Mortgages,"(3) which recites that it "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."

This article is an attempt to explain the scope of the new law, as interpreted in the memorandum, insofar as it relates to spreader agreements and additional mortgages. Unfortunately, the memo leaves many questions unanswered.

[Understanding the Law](#)

The new law amended Tax Law § 255 ("Supplemental Mortgages") to apply mortgage tax to a "spreading agreement or additional mortgage" recorded in the City of New York when the lien of a mortgage is imposed on property not originally encumbered, unless the additional property is owned by the mortgagor of the real property subject to the recorded, primary mortgage (original mortgagor) or, in certain circumstances, a party "related" to the original mortgagor.(4)

A restatement of an example in the memo identifies the type of transaction intended to be dealt with.

A \$100,000 mortgage was recorded against Property 1 owned by Owner 1 and mortgage recording tax was paid. Owner 2 of Property 2 wishes to obtain a mortgage loan of \$100,000. Owner 1, Owner 2 and the holder of the mortgage enter into an agreement whereby the lien of

the mortgage on Property 1 is "spread" to encumber Property 2. The obligations under the mortgage note are assumed by Property Owner 2, the mortgage, as spread, is released from Property 1, Owner 1 is released from the obligation to repay the note, and the mortgage is assigned to Owner 2's new lender. Instead of paying off its mortgage debt, Owner 1 pays the \$100,000 to Owner 2, and Owner 2 pays Owner 1 a fraction of the mortgage tax that Owner 2 did not have to pay to compensate Owner 1 for undertaking the transaction. Owner 2 and New Lender amend and restate the note and the mortgage. Affidavits are submitted under Tax Law § 255 with the recording of each of the spreader agreement and the restated mortgage affirming that no new indebtedness or obligation is secured.

While City Finance and the Department have not looked favorably upon this practice, the two entities have not been aggressive in dealing with it. Tax Law §255 (1)(a)(1) exempts from payment of mortgage tax a supplemental mortgage which imposes a lien on property to secure the same principal indebtedness as is secured by another primary mortgage on which tax was paid.(5) Accordingly, mortgage tax has generally only been imposed when a mortgage is being spread into a county in which a higher mortgage tax rate is in effect. In such circumstances, the difference in rates is applied to the outstanding principal indebtedness.(6)

Although the new law impacts "additional mortgages," the memo suggests that a mortgage given as additional collateral security in the usual case will continue to be exempt from mortgage tax under §255 even when the additional property is not owned by the primary mortgagor or a "related party." It defines the "additional mortgage" intended to be addressed by the new law to be an instrument other than a spreader agreement effectively imposing the lien of an existing mortgage on other property when the owner of that other property becomes the obligor. It further states that an instrument spreading the lien of a recorded primary mortgage to property owned by an unrelated party as additional collateral security for the indebtedness of the original mortgagor will not be subject to tax, provided that the original mortgagor is not released from the note or other evidence of indebtedness secured by the primary mortgage.

The memo sets forth presumptions and safe harbor exceptions for application of the tax.

A spreader agreement and an additional mortgage — which will be referred to collectively for the remainder of this article as "spreader" — are deemed to be for a "legitimate business purposes," and therefore not subject to the payment of additional mortgage recording tax, in the following additional instances:

1. The owner of the property interest encumbered by the recorded, primary mortgage is the owner of the property to which the mortgage is spread.

2. Real property becomes subject to the lien of a mortgage under an "after-acquired property" clause in the mortgage or the real property is included in the security under a blanket mortgage. The Memo does not define the import of a blanket mortgage in this context.
3. 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, in the same property. This should presumably also allow for the spreading of a mortgage from lease to a fee interest without payment of additional tax.
4. The recording of an instrument to sever and modify the lien of a recorded primary mortgage to reflect a declaration of condominium ownership or subdivision. This should allow any severance of a primary mortgage, such as the severance of a blanket mortgage into substitute mortgages for assignment to the lenders for unit owners.
5. The recording of an instrument to sever and modify the lien of a recorded primary mortgage to reflect the replacement of construction financing with permanent financing. It is not clear when this would apply.
6. The recording of a spreader to encumber real property to be acquired by the mortgagor in a IRC § 1031 exchange.
7. The recording of a spreader where the real property to be added to the lien of the primary mortgage is owned by a person "related to" the original mortgagor, provided the original mortgagor is not released from the debt instrument (e.g., note) secured by the mortgage. The Memo does not indicate if the obligation of the original mortgagor can be modified to become non-recourse.

Spreading the lien of the primary, recorded mortgage to property owned by a "related party" requires that the property have been acquired by the "related party" no less than 12 months prior to the recording of the spreader. If the property was acquired within the 12 month period there is a rebuttable presumption that the property was acquired by the "related party" to avoid payment of the tax. Unless that presumption is rebutted by "clear and convincing" evidence to the contrary, mortgage tax will be payable on recording of the spreader.

Rebutting the Presumption

To rebut the presumption that the "related party" acquired its property interest within the prior 12 months to avoid payment of tax, the § 255 affidavit submitted when the spreader is tendered for recording must "expressly state the independent business or financial purpose" of the spreader. A statement to the effect that the mortgagee requires additional collateral may be a sufficient recitation. In addition, the § 255 affidavit will need to "affirmatively state" the following text set forth in the memorandum:

"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 recorded primary mortgage."

Notwithstanding that the § 255 affidavit contains those recitations, the memo also suggests that a spreader imposing a mortgage on property owned by a related party will be taxed if within 12 months prior to recording the spreader the related party took title to its property interest from a non-related party. The related party "is intended to dispose of its ownership . . . shortly after the spreader transaction is completed," the real property originally subject to the mortgage is to be released as part of the spreader transaction, and the original debtor "is to be released" from its obligation to repay the indebtedness "as part of the same transaction." It may be the case that the spreader will be later taxed if the original mortgagor is released from the obligation or its property is released from the lien of the mortgage at any time after the spreader is recorded.

"Related parties" are identified in the memo as being the following persons:

1. Members of a family, including spouses, ancestors, lineal descendants, and brothers and sisters (whether by the whole or half blood).
2. 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. 7
3. 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.
4. 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.
5. A grantor of a trust and a trust.
6. 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. It may be the case that in determining whether ownership of an entity is in a "related party," the ultimate beneficial ownership will have to be established and maintained. When a mortgage is spread to property owned by an entity which is a "related party," the lender may deem it prudent to prohibit the transfer of any beneficial interest in that entity.

While the memo attempts to provides a roadmap for application of the new law, without further clarification by the Department or new legislation rewriting Part Q, it can be expected that additional questions will arise on how to apply the new law to spreaders. For example, how will the Department apply these rules when a mortgage on property in the City of New York is spread to property outside the City since the spreader agreement is recorded against both properties, notwithstanding that new law only applies to property in the City? Will a subsequent transfer of interests in the original, primary mortgagor require the payment of mortgage tax when a spreader agreement was previously recorded?

Since seeking even informal advice on a case by case basis from knowledgeable personnel in the Department's Technical Services Division has become difficult to obtain, anyone structuring a spreader transaction intending to claim that mortgage recording tax is not payable under the new law, as interpreted by the memo, is cautioned to seek guidance from the Department, directly or through a title company or title agent, well in advance of closing. In certain instances, a written Advisory Opinion from the Department may be advisable.

Endnotes:

1. The new law applies to mortgages recorded in a city in New York State having a population of one million or more.
2. Application can be made for the refund of mortgage tax paid for recordings made on or after Nov. 18 and before Jan. 17 to comply with the the new law. See TSB-M-04(12)R posted at http://www.tax.state.ny.us/pubs_and_bulls/memos/mortgage_rec_memos.htm. The author has been advised that the effective date of the new law was extended to enable New York City's Department of Finance an opportunity to modify its Automated City Register Information System (ACRIS) to include in its cover page module questions which could, depending on the entry made in response by the user, require the payment of additional mortgage recording tax when there is a spreader agreement, an additional mortgage, or the refinancing of an existing mortgage included in a wraparound mortgage.
3. The Memo is available at http://www.tax.state.ny.us/pubs_and_bulls/memos/mortgage_rec_memos.htm
4. The new law defines "related parties" by application of the relationships in Tax Law § 253-a(2)(B), applying a 25 percent instead of a 50 percent standard, where indicated in § 253.
5. See also Matter of the City of New York v. Tully, 55 NY2d 960, 449 NYS 2d 181 (1982). According to the Court of Appeals, "(i)t is significant that the release of the leasehold from the lien did not occur before the fee was added to the security for the principal indebtedness."
6. 20 NYCRR Section 645.2 ("Imposition of taxes upon recording of a supplemental mortgage.")
7. Related parties are generally identified in the new law and in the Memo as having at least a 25 percent identify of interest with the original mortgagor. However, part of the Answer to Question A9 of the Memo uses a 50 percent test. It is uncertain whether the reference to 50 percent is an error or if it has an independent meaning.

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