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REAL ESTATE ADVISORY

UPDATE: Proposed Taxes on Mezzanine and Preferred Equity Financing Resurface in New York Legislature

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KEY POINTS

- New York lawmakers have reintroduced legislation that, if adopted into law, would make mezzanine and preferred equity financing subject to the mortgage recording tax.

- The legislation would also require mezzanine lenders and preferred equity investors to file UCC-1 financing statements in the county land records in order to perfect their security interests and enable them to exercise remedies under Article 9 of the Uniform Commercial Code.

- Proposals for mezzanine and preferred equity taxes were introduced by lawmakers during the 2019–2020 and 2021–2022 legislative sessions, but in each case were not adopted into law before the end of the legislative session.

On January 4, New York lawmakers introduced legislation in the New York State Senate that would require mortgage recording tax to be paid on mezzanine and preferred equity financing in cases where such financing is subordinate to primary mortgage debt (a Mezzanine Tax). The same legislation was introduced in the New York State Assembly on January 9.

This is the third straight legislative session in which New York lawmakers have pushed to enact a Mezzanine Tax. The same legislation had been proposed in the 2019–2020 and 2021–2022 legislative sessions, but in each case the proposal died in committee when the legislative session ended. A proposal to include a Mezzanine Tax in the state's 2021–2022 budget also failed.

Although those efforts failed, New York lawmakers have revived Mezzanine Tax legislation for the 2023–2024 legislative session.

If adopted into law, the proposed Mezzanine Tax would impose mortgage recording taxes on mezzanine and preferred equity financing transactions where the mezzanine or preferred equity financing is "related to the real property upon which a mortgage instrument is filed." The mortgage recording tax in New York State varies by locality but can be as high as 2.8 percent in New York City for mortgages on commercial real estate with principal amounts over $500,000. Remedies under the New York Uniform Commercial Code (UCC) would not be available to the mezzanine lender or preferred equity investor unless the mortgage recording tax was paid.

The legislation also would amend the UCC to provide that a security interest with respect to such mezzanine debt or preferred equity investment may be perfected only if a UCC-1 financing statement is filed.

The persistence of Mezzanine Tax legislation in the New York legislature is troubling, in part because of the obvious additional tax burdens that a Mezzanine Tax would impose on mezzanine and preferred equity borrowers. Other concerns include:

- Due to the vagueness of the language included in the Mezzanine Tax legislation (which states that the Mezzanine Tax would apply to "non-traditional financing techniques"), the Mezzanine Tax could be held to apply to financing transactions where real estate is not the primary focus of the transaction, or in other contexts where mortgage recording tax would not be expected to be applicable. For example, the Mezzanine Tax might be construed to apply to corporate financing transactions where the underlying assets include real estate, or in a joint venture where one investor has a right to a preferred rate of return.
- The application of the proposed Mezzanine Tax in the context of preferred equity is unclear. The Mezzanine Tax legislation references security interests and remedies under the UCC. However, unlike mezzanine loans, preferred equity investments typically are not secured by security interests under the UCC, and a preferred equity investor would not typically file a UCC financing statement.
- It also is not clear whether mezzanine lenders or preferred equity investors would be permitted to assign existing debt (or, in the case of preferred equity investors, to assign existing preferred equity) to incoming lenders in order to reduce mortgage recording tax costs, as is the case with mortgage lenders.
- Another question is how the Mezzanine Tax would be applied in a multistate transaction involving multiple real property assets located in New York and other states.

Katten will continue to monitor developments with regard to the Mezzanine Tax legislation.

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