

The Changes Continue

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New York Assembly-Sponsored Legislation Proposes New Tax on Mezzanine Debt and Preferred Equity



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Assembly Bill A3139 was introduced by Assembly Member Harvey Epstein on January 22, 2021. The bill is currently in committee but, if enacted, it will amend New York's Real Property Law and Tax Law to require the recording of mezzanine debt and preferred equity investments and subject it to the mortgage recording tax. These amendments will force borrowers and lenders to reconsider the economic costs of mezzanine financing.

The first major change is the requirement for the recording of mezzanine debt and preferred equity investments entered into simultaneously with mortgages secured by real property. If enacted, the law will amend Real Property Law, Section 291-k to require mezzanine debt or preferred equity investments to be recorded whenever a corresponding mortgage is recorded against real property. This provision encompasses "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 financing such primary lien." The proposed bill specifies that the definition includes "non-traditional financing techniques such as direct or indirect investment by a financing source in an entity that owns the equality [sic] 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." It does not encompass, however, debt on cooperative or common shares of residential units where (i) the unit owner of a cooperative apartment is a shareholder of the ownership entity, (ii) has exclusive occupancy of such dwelling unit, and (iii) has established and delimited rights under a proprietary lease. Section 9-601 of the Uniform Commercial Code (the "UCC") would be amended to provide that security interests in mezzanine debt and preferred equity related to real property will be perfected only by the filing of a financing statement and payment of any taxes due. While not 100% clear from the proposed language of the bill, it appears that the bill would require the recording of mezzanine security instruments along with their mortgage counterparts.

The proposed bill would also amend Section 250(2)(a) of the Tax Law to provide that "mezzanine debt" and "preferred equity investments", as defined in Section 291-k of the Real Property Law, are now taxable. Section 253 of the Tax Law would be amended so that the tax would be imposed upon the filing of a financing statement and measured by the amount of the principal debt obligation secured by a security agreement pertaining to mezzanine debt financing and/or preferred equity investments in relation to real property upon which a mortgage instrument is filed. The proposed rate of tax would be as follows: (i) mezzanine debt and preferred equity investments of less than \$500,000 will be taxed at \$1 per each \$100 of debt secured; (ii) mezzanine debt and preferred equity investments affecting one, two, or three-family houses and individual residential condo units securing \$500,000 or more will be taxed at \$1.125 per each \$100 of debt secured; and (iii) mezzanine debt and preferred equity investments of all other real property will be taxed at \$1.75 for each \$100 of debt secured. Counties and cities will also be authorized to adopt and/or amend local laws to impose a county or city tax on the filing of financing statements pertaining to mezzanine debt and/or preferred equity investments. Additionally, Section 291-k of the Real Property Law would be amended to provide that no remedy otherwise available under Article 9 of the UCC will be available to enforce such mezzanine debt unless the contemplated taxes have been paid. The bill is silent as to any restriction on the enforcement of remedies available to a preferred equity interest short of remedies available pursuant to the UCC.

The proposed bill is unclear, however, on whether the foregoing amendments will apply to mezzanine debt unrelated to underlying mortgage debt. The current language appears to encompass mezzanine debt whenever “a mortgage instrument is recorded” but it does not expressly address mezzanine debt that is created independent of debt secured by real property. Consequently, it remains to be seen whether the proposed law will apply to just mezzanine debt subordinate to a primary mortgage loan secured by real property or to all mezzanine debt generally.

Assembly Bill A3139, if passed, will impose significant new requirements for mezzanine debt and preferred equity investments transactions. Under the proposed legislation (like the mortgage tax in New York) lenders will be required to file and pay tax on mezzanine debt and preferred equity investments as a precondition to exercising remedies. A similar bill was introduced in January and August of 2020, both of which died in committee. If this legislation moves forward, we will update this Article.