

Enforcing Mezzanine Loans Triggers Transfer Taxes

Calculating how and how much.

BY JOHN M. ZIZZO,
BONNIE A. NEUMAN
AND MICHAEL J. BERESY

FOR THE PAST several years, lenders have structured subordinate loans on real estate in the form of mezzanine loans, secured by pledges of equity interests in the owners of the real property. As the economic climate and real estate market continue to change, defaults under such mezzanine loans are likely to increase.

A mezzanine lender's remedy in the event of such a default will typically be limited to foreclosing on the pledges of their borrowers' equity interests or taking the same through assignments in lieu of foreclosure. When a mezzanine borrower pledges its equity interest in the owner of real property in New York City, foreclosing on such equity pledge, or taking an assignment in lieu, will subject the lender to New York state and New York City transfer taxes.

This article explores the application of these transfer taxes to the enforcement of mezzanine loans, setting forth examples of how the authors believe the transfer taxes will be applied.

Historical Background

New York state and New York City real estate transfer taxes initially applied only to the transfer of real property by deed.¹ Real property could be transferred without the payment of tax by transferring interests in the entity owning real property.²

In response to the sale of the corporation that owned the Pan Am building in Manhattan, the New York state Legislature amended New York City's real property transfer tax (RPTT) to impose

the RPTT on transfers of controlling economic interests.³ The legislative history notes that "this bill closes that loophole by permitting the taxation of transfers of controlling interests in corporations, partnerships, associations, trusts and other entities which own real property. As a result, transactions which effectively, albeit indirectly, convey property will now be taxed."⁴

The RPTT, according to the court in *595 Investors Limited Partnership v. Biderman*,⁵ would be "rendered a nullity if it could be avoided simply by holding the real property through passive corporations or partnerships." Transfers of interests in an upper-tier entity existing principally for the purpose of holding stock in a subsidiary owning real property not substantially engaged in other bona fide activities are also subject to tax.⁶

New York State Transfer Tax

Article 31 of the Tax Law imposes real estate transfer tax (RETT) on each conveyance of real property or interest in real property when the consideration exceeds \$500, at a rate of \$2 for each \$500 of consideration or fractional part thereof.⁷

A "conveyance" of real property has, since July 1, 1989, included the transfer or transfers by a person or group of persons acting in concert of a controlling interest in any entity with an interest in real property.⁸ A "controlling interest" is, in the case of a corporation, either 50 percent or more of the total combined voting power of all classes of stock of such corporation, or 50 percent or more of the capital, profits or beneficial interests in such voting stock of such corporation and in the case of a partnership, association, trust or other entity, 50 percent or more of the capital, profits or beneficial interest in such partnership, association, trust or other entity.⁹

Generally, multiple transfers of a controlling interest in the same entity will be aggregated for the computation of tax; however transfers in the same entity that occur more than three years apart will not be aggregated, unless such transfers were

timed as part of a plan to avoid transfer tax.¹⁰

Section 575.11(16) of 20 NYCRR provides that "a conveyance of real property pursuant to a secured party's enforcement of a lien, security interest or other rights on or in shares of stock, partnership interests or other instruments, upon default by a debtor (i.e., the transfer or acquisition of a controlling interest in an entity with an interest in real property), is subject to tax."¹¹ Consideration for a conveyance, such as a mezzanine foreclosure, or an assignment in lieu of foreclosure, where the grantee is the secured party, or its agent or nominee or an entity wholly owned by such secured party, regardless of whether the debt is recourse or nonrecourse,¹² is the lesser of the following:

"(i) the fair market value¹³ of the real property as of the date of the conveyance multiplied by the percentage in the entity being transferred or acquired or

"(ii) the sum, which includes, but is not limited to

"(a) a reasonable apportionment to the interests in real property owned by the entity of the unpaid balance of the debt secured by the ownership interest in the entity,

(b) a reasonable apportionment to the interests in real property owned by the entity of the amount of any liens, security interests or other obligations remaining on the ownership interest in the entity after the conveyance, whether the underlying indebtedness is assumed or taken subject to,

(c) a reasonable apportionment to the interests in real property owned by the entity of the amount of any liens or encumbrances remaining on the real property of the entity multiplied by the percentage in the entity being transferred or acquired,

(d) a reasonable apportionment to the interests in real property owned by the entity of the amount of any other debt or obligation of the entity multiplied by the percentage in the entity being transferred or acquired and

JOHN M. ZIZZO is a partner and BONNIE A. NEUMAN is an associate in the corporate department at Cadwalader Wickersham & Taft. MICHAEL J. BERESY is general counsel and senior vice president at First American Title Insurance Company of New York.

(e) a reasonable apportionment to the interests in real property owned by the entity of any other amount paid by the grantee for the conveyance."¹⁴

Though the state's RETT regulations do not deal specifically with the purchase by a successful bidder in the context of a mezzanine loan, where the grantee is a third-party bidder, consideration is believed to be the sum of:

- (i) the amount of the successful bid,
- (ii) the amount of any surviving liens on the mezzanine interest being foreclosed, including the unpaid balance of any senior mezzanine loans, and
- (iii) the unpaid balance of any mortgage on the real property.

The fair market value cap available to the foreclosing lender or its nominee does not apply.¹⁵

New York City Transfer Tax

The RPTT is imposed on each instrument or transaction whereby any controlling economic interest in real property located in New York City is transferred.¹⁶ The applicable commercial rate of tax will be 2.625 percent if consideration is more than \$500,000, as is typical in the enforcement of a mezzanine loan.¹⁷

An "economic interest in real property" is the ownership of "shares of stock in a corporation which owns real property, the ownership of an interest or interests in a partnership, association or other unincorporated entity which owns real property and the ownership of a beneficial interest or interests in a trust which owns real property."¹⁸

A "controlling economic interest" (a "controlling interest"), in the case of a corporation means 50 percent or more of the total combined voting power of all classes of stock of the corporation; or 50 percent or more of the total fair market value of all classes of stock of the corporation.¹⁹ A controlling interest in the case of a partnership, association, trust or other unincorporated entity means 50 percent or more of the capital, profits or beneficial interest in the partnership, association, trust or other unincorporated entity.²⁰ Transfers made within a three year period are presumed to be related and are aggregated, unless the grantor(s) or grantee(s) can prove that the transfers are unrelated.²¹

In the case of the transfer of a controlling interest in real property, a proportionate share of the unpaid principal balance of any mortgage on the real property is added to the amount paid for the interest(s) in a corporation, trust, partnership, association, or other unincorporated entity.²² Where the entity whose stock or ownership interest is being transferred owns other assets in addition to real property, only the consideration attributable to the real property is subject to tax.²³

When a controlling interest is transferred to a secured party or its nominee, or to a third party bidder, pursuant to a mezzanine loan foreclosure, consideration is the sum of the (i) amount of the successful bid, (ii) amount of any other surviving liens on the mezzanine interest being foreclosed, including the unpaid balance of any more senior mezzanine loans and (iii) unpaid balance of any outstanding mortgage on the real property.²⁴

Consideration for the RPTT will also include costs of the foreclosure paid by the transferee.²⁵ It is believed that consideration will also include any other debt of the property owning entity.

On an assignment in lieu of a mezzanine interest, consideration will include the unpaid balance due on the mezzanine loan instead of a bid amount. There is for the RPTT no fair market value cap.²⁶

Note that when the transferee of the mezzanine interest pays the transfer taxes due on an assignment in lieu, the amount of taxable consideration is increased by the amount of tax so paid, and tax is applied to that grossed-up amount.²⁷

Application of Transfer Taxes

Determining the consideration to be taxed in a mezzanine foreclosure may have an impact on the decision whether to foreclose or continue negotiating a workout. The following examples apply the RPTT and the RETT to typical situations that may be seen in the context of mezzanine financing.²⁸

Example 1. X is the owner of 100 percent of the limited liability company (LLC) interests in Y and Y is the owner of 100 percent of the LLC interests in Z. Z's only asset is a parcel of real property located in New York City. The fair market value of the real property is \$2 million. The real property is encumbered by the lien of a mortgage having a current unpaid balance of \$1.5 million, held by B Bank. X pledged its 100 percent LLC interest in Y to C bank as security for a mezzanine loan of \$400,000, the current unpaid balance of which is \$450,000, including accrued interest. There are no other outstanding loans.

C is presently enforcing its security interest in the LLC interest in Y, which results in both a transfer and acquisition of a controlling interest. Assume for purposes of Example 1 that C's successful bid at foreclosure is equal to the amount of the outstanding debt.

RETT: The consideration is computed as the lesser of:

(1) (a) the \$450,000 outstanding debt plus (b) the \$1.5 million outstanding mortgage loan, equal to \$1,950,000, or

(2) fair market value (FMV) of the real property, which is \$2 million.

The consideration is \$1.95 million.

RPTT: The consideration is computed as (1) (a) the \$450,000 successful bid plus (b) the \$1.5 million outstanding mortgage loan.

The consideration is \$1,950,000.

Example 2. Consider the same structure as in Example 1 above, however, Y has also pledged its LLC interest in Z to D bank as collateral for a \$300,000 senior mezzanine loan, which has an unpaid balance of \$350,000, including unpaid interest. C bank is seeking to foreclose on X's pledge of its interest in Y. C is the successful bidder.

RETT: The consideration is computed as the lesser of

(1) (a) the \$450,000 outstanding debt plus (b) the outstanding senior loan debt of \$350,000 plus (c) the \$1.5 million outstanding mortgage loan, equal to \$2.3 million, or

(2) FMV of the real property, which is \$2 million.

The consideration is \$2 million.

RPTT: The consideration is computed as:

(1) (a) the \$450,000 successful bid plus (b) the outstanding senior loan debt of \$350,000 plus (c) the \$1.5 million outstanding mortgage loan, equal to \$2.3 million.

The consideration is \$2.3 million. Note that the RPTT does not have an FMV cap.

Example 3. Consider the structure outlined in Example 1 above; however, in C's foreclosure sale to enforce its security interest in X's shares of Y, a third party, E, is the winning bidder, with a bid of \$300,000.

RETT:²⁹ The consideration is (a) the \$300,000 winning bid price and (b) the \$1.5 million mortgage loan which represents the remaining senior liens or encumbrances on the real property after the conveyance.

RPTT: The RPTT does not distinguish between a foreclosure sale where the secured party is the winning bidder and where there is a third party bidder.

The consideration for both taxes is \$1.8 million.

Example 4. Consider the structure outlined in Example 1 above; however, C enforces its security interest in X's shares of Y, by obtaining an assignment in lieu of foreclosure in its favor.

RETT: The consideration is the lesser of:

(1) (a) the \$450,000 outstanding balance of the mezzanine loan and (b) the \$1.5 million mortgage loan which represents the remaining senior liens or encumbrances on the real property after the conveyance or

(2) FMV of the real property, which is \$2 million.

The consideration is \$1.95 million.

RPTT: The consideration is

(1) (a) the \$450,000 outstanding balance of the mezzanine loan and (b) the \$1.5 million mortgage loan which represents the remaining senior liens or encumbrances on the real property after the conveyance.

The consideration is \$1.95 million.

Example 5. S is the owner of 100 percent of the voting stock of K Corporation. K is the owner of 100 percent of the voting stock of L. L's assets consist of a parcel of real property located in New York City and other tangible assets. The FMV of the parcel of real property is \$2.1 million and the FMV of the other assets is \$300,000. The real property is encumbered by the lien of a mortgage having a current unpaid balance of \$700,000. Also, L has other debts totaling \$300,000. S pledged 100 percent of its stock in K to J as security for a \$500,000 mezzanine loan, which has an unpaid balance of \$550,000, including secured interest. J is presently enforcing its security interest in the voting stock owned by S, which results in both a transfer and an acquisition of a controlling interest with its winning bid at foreclosure of \$550,000.

RETT: The consideration is the lesser of:

(1) the FMV of the real property, which is equal to \$2.1 million, or

(2) the apportioned value of³⁰ (a) the \$550,000 unpaid balance of the mezzanine loan, (b) the

\$700,000 outstanding mortgage debt plus (c) the \$300,000 in other debt of the entity. The total amount to be apportioned is \$1,550,000.

Apportionment is then calculated as follows:

The FMV of the real property, multiplied by the amount to be apportioned, divided by the FMV of all assets.

The apportioned amount is:

$$\frac{\$1,550,000 \times \$2,100,000}{\$2,400,000} = \$1,356,250$$

The consideration is \$1,356,250.

RPTT:

The consideration should be computed as:

The apportioned value of (a) the \$550,000 successful bid at foreclosure of the mezzanine loan, plus (b) the \$700,000 outstanding mortgage debt plus (c) the \$300,000 in other debt of the entity. The total amount to be apportioned is \$1,550,000.

Apportionment is calculated as follows:

The FMV of the real property, divided by the FMV of all assets, multiplied by the consideration to be apportioned.

The apportioned amount is:

$$\frac{\$1,550,000 \times \$2,100,000}{\$2,400,000} = \$1,356,250$$

The consideration should be \$1,356,250.

Example 6. Consider the same structure as Example 5, however, S only has a 60 percent interest in K, which it pledges to J as security for a debt of \$500,000, with an outstanding balance of \$550,000, including accrued interest.

RETT: The consideration is the lesser of:

(1) FMV of the real property multiplied by the equity interest being transferred, that is, \$2.1 million, X 60 percent = \$1,260,000 or

(2) the apportioned value of (a) the \$550,000 unpaid balance of the mezzanine loan, plus (b) the outstanding mortgage debt multiplied by the equity interest being transferred, that is, \$700,000 X 60 percent = \$420,000, plus (c) additional debt of the entity multiplied by the equity interest being transferred, that is, \$300,000 X 60 percent = \$180,000. The amount to be apportioned is \$1,150,000.

Apportionment is calculated as follows:

$$\frac{\$1,150,000 \times \$2,100,000}{\$2,400,000} = \$1,006,250$$

The consideration is \$1,006,250.

RPTT: The consideration should be:

the apportioned value of (a) the \$550,000 successful bid at foreclosure of the mezzanine loan, plus (b) the \$700,000 outstanding mortgage debt multiplied by the equity interest being transferred, that is, \$700,000 X 60 percent = \$420,000, plus (c) additional debt of the entity multiplied by the equity interest being transferred, that is, \$300,000 X 60 percent = \$180,000.

The amount to be apportioned is \$1,150,000.

Apportionment is calculated as follows:

$$\frac{\$1,150,000 \times \$2,100,000}{\$2,400,000} = \$1,006,250$$

The consideration should be \$1,006,250.

Conclusion

As evidenced by the above examples, transfer taxes will need to be taken into consideration before a lender acquires a mezzanine interest by foreclosure or by an assignment in lieu, or before any other person purchases a mezzanine interest being foreclosed.

.....●●.....

1. *In the Matter of Petitions of the Chase Manhattan Corporation (f/k/a Chemical Banking Corporation) and Shareholders of the Chase Manhattan Corporation*, No. TAT(H) 99-99(RP), TAT(H) 99-100(RP), 2005 N.Y. Tax LEXIS 28, at *29.

2. *Id.*

3. *Id.*

4. Governor Carey's approval letter; 1981 N.Y. Sess. Laws pp. 2636-37 (McKinney).

5. 140 Misc. 2d 441 (Sup. Ct. N.Y. County 1988).

6. *Id.* See also *Matter of Corwood Enterprises Inc.*, Decision of the NYC Tax Appeals Tribunal, TAT(E)00-39 (RP, 2006).

7. N.Y. Tax Law §1402.

8. Tax Law §1401(e); 19 RCNY §575.1. See Michael J. Berey, "The Mere Change Exemption and Controlling Interests Transfers," METES AND BOUNDS, Winter 2000, Volume 6, No. 3 (Association of the Bar of the City of New York), available at <http://www.firstamny.com/doc/617.pdf>.

9. N.Y. Tax Law §1401(b); 20 NYCRR § 575.1.

10. *Id.*

11. While the state regulations do not specifically address how consideration for tax is computed when a mezzanine interest that is a controlling interest is transferred to the lender or its nominee prior to the occurrence of a formal event of default, the authors believe that consideration would be the sum of (i) the amount of unpaid indebtedness due to the transferee, (ii) the unpaid balance of any senior mezzanine debt, (iii) the unpaid balance of any fee mortgage, (iv) the amount of any other surviving liens on the mezzanine interest, and (v) any other amount paid by the grantee, including transfer taxes contractually assumed by the grantee. 20 NYCRR §575.11(a)(3).

12. Whether or not the indebtedness is recourse or non-recourse is inapplicable to the computation of taxable consideration on the foreclosure of a mezzanine loan or the in lieu transfer of the interest of the borrower to a mezzanine lender.

13. Fair market value means the amount that a willing buyer would pay a willing seller for real property. It is generally determined by an appraisal of the real property at the time of the conveyance and does not take into account outstanding mortgages. 20 NYCRR §575.1(l).

14. 20 NYCRR §575.11(a)(16).

15. See 20 NYCRR §575.11(a)(3)(ii) setting forth consideration in the context of a mortgage loan foreclosure where the successful bidder is a third party.

16. 19 RCNY §23-03(a)(2)(i).

17. 19 RCNY §23-03(c)(4).

18. 11 N.Y. CITY ADMIN. CODE §11-2101(6).

19. 11 N.Y. CITY ADMIN. CODE §11-2101(8).

20. *Id.*

21. *Id.*

22. 19 RCNY § 23-02(3).

23. Although the city's regulations do not specifically apply these regulations in the context of a mezzanine loan foreclosure, it is believed that they would be applied and the computations in Examples 5 and 6 following are computed on that basis:

"In the case of the transfer of a controlling economic interest in real property, a proportionate

share of the amount of any mortgage on the real property must be added to the amount paid for the stock in a corporation or the interest(s) in a trust, partnership, association, or other unincorporated entity" 19 RCNY §23-02, Definition, "Consideration in the Case of Transfers of Controlling Economic Interests," (Italics added)

"In the case of a transfer of an economic interest in an entity that owns assets in addition to real property or interest therein, the consideration subject to tax shall be deemed equal to the fair market value of the real property or interest therein *apportioned* based on the percentage of the ownership interest in the entity transferred." NYC Admin Code Section §11-2102(d). (Italics added).

24. 19 RCNY §23-03(d)(2).

25. *Id.*

26. *Id.*

27. 20 NYCRR §575.11(a)(3)(ii); 19 RCNY §23-02. In both the state and city interpretative regulations, the gross-up is required where a grantee contractually agrees to pay the transfer taxes due on a conveyance. In practice, this is broadly interpreted such that there is a gross-up if the grantee pays the transfer tax due in nearly all instances.

28. The examples in this section were based both directly and indirectly on examples given by the state and city in the interpretive regulations. See 19 RCNY §23-03 and 20 NYCRR Part 575.

29. The authors do not believe there is a fair market value cap where a third party is the successful bidder.

30. Given that there are assets other than real property involved in the structure and only a portion of the interest being foreclosed upon is attributable to real property, consideration must be apportioned based on the FMV of assets owned by L. See footnote 23.