THE MORTGAGE OBSERVER

The M.O. Columnists / July-August 2012 Issue - Page 16

Stein's Law

Clarity On How Mortgage Recording Tax Applies To Interest Rate Swaps

New York prides itself on being the capital of capital. But it imposes on real estate financing transactions a peculiar tax—the New York mortgage recording tax—that creates spurious issues and problems for many elements of modern sophisticated financing transactions. To the state's credit, though, it recently clarified how that wretched tax applies to a technique that borrowers and lenders often use to hedge interest rate risk. In doing so, the state passed up an opportunity to impose yet a further burden and gratuitous complexity on commercial real estate finance transactions.


Joshua Stein

The potential problem arises whenever a borrower obtains a floating-rate loan and also enters into an interest rate swap to convert that floating rate into a fixed rate. If rates go down and then the borrower goes into default, the swap may terminate and require the borrower to pay a termination payment, which can be substantial. The borrower will typically need to have its real property secure the obligation to make that payment.

Until recently, industry participants sometimes feared that the state might impose a mortgage recording tax to the extent that a mortgage secured a possible swap termination payment. Tax officials had sometimes suggested that if a mortgage secured a swap termination payment, that was just like securing an obligation to pay a principal debt in the same potential amount—i.e., an obligation that would attract a mortgage recording tax of up to 2.8 percent.

The industry generally ignored that position. New York borrowers routinely gave their lenders mortgages to secure swap termination payments for swaps the borrower obtained for the same loan that the mortgage otherwise secured. Even though tax officials had sometimes made noises to the contrary, the industry believed that these mortgages could secure swap termination payments without incurring additional mortgage recording tax.

In early June, the state's Department of Taxation and Finance issued a ruling basically accepting the industry's position on how to treat swap termination payments for mortgage recording tax purposes. In order to avoid incremental tax on those payments, the ruling made it clear that the transaction just needs to satisfy a few conditions that are not onerous.

First, the mortgage documents need to refer

Continued...

THE MORTGAGE OBSERVER

The M.O. Columnists / July-August 2012 Issue - Page 16

Continued from page 1

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to the swap termination payments as "additional interest." That's a reasonable requirement, because that's what a termination payment effectively is—an accelerated payment of some of the fixed interest that the borrower agreed to pay by entering into the swap but had to pay earlier because the borrower went into default.

Second, the swap termination payment can't be secured by a separate mortgage with a separate stated principal amount. This would take the payment too close to being principal indebtedness, and it does not seem unreasonable to impose a tax in that case. The same problem would arise if a single mortgage secured both the loan and a stated dollar amount of potential swap termination payment. Instead, one mortgage should secure both the loan and a generic nonquantified swap termination payment.

Third, the termination payment needs to arise from a swap issued for the same loan that the mortgage secures. That's a reasonable requirement too. Without it, the swap termination payment really would be nothing more than a potential obligation to pay a "bad bet"—something that should be treated as taxable principal indebtedness. But parties must still beware of "dragnet" language that might make a mortgage secure not only a loan-related swap, but also termination payments arising under other swaps for other loans or transactions.

Finally, the swap needs to relate to an amount of indebtedness equal to the mortgage loan. This requirement goes a bit too far. It shouldn't matter if a swap relates to, say, only half the mortgage loan. The borrower and the lender should be free to decide they don't need to hedge the entire interest-rate risk of the loan, just part of it. And in that case there's no reason to deny tax-free treatment to the swap termination payment. Did the state really intend to do that?

Setting aside that last detail, the state's treatment of swap termination payments seems practical, reasonable and consistent with industry expectations. And with the same exception, the new ruling also conforms to the tax treatment of swap termination payments that I summarized and recommended in my book on New York commercial mortgage transactions. In fact, some of the language in the state's ruling echoes the language I used in my description of this entire issue and how I thought—and how the industry believed—the taxation of swap termination payments should work. It's a pleasure and an honor to see my language copied in this way.

I'd be even happier if the state adopted some of my language on how the mortgage tax should treat revolving loans. More on that in the next issue.

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