A Simple Proposal to Simplify New York's Mortgage Recording Tax

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Now that New York State has repealed the Cuomo Tax, the state should take a serious look at other steps it can take to simplify New York real estate transactions and bring them more into line with real estate transactions elsewhere in the United States.

The state should focus next on the mortgage recording tax. Aside from being higher, by about 300% in New York City, than the highest mortgage recording tax in any other state, this tax inflicts unnecessary and gratuitous complexity, paperwork, and opportunity for error upon almost every real estate finance transaction in New York State.

> *"Aside from being higher, by about 300% in New York City, than the highest mortgage recording tax in any other state, [the mortgage recording tax] inflicts unnecessary and gratuitous complexity, paperwork, and opportunity for error upon almost every real estate finance transaction in New York State."*

The mortgage recording tax should — and easily can — be simplified to eliminate this entire burden. Whether the tax should also be reduced is an issue for another day. As long as New York imposes any mortgage recording tax at all, that tax can and should be simplified. The simplification proposed here would be more likely to increase than decrease tax revenues.

The mortgage recording tax is imposed on the recording of a mortgage, or any other instrument that increases the indebtedness secured by an existing mortgage. It can therefore be considered a tax on partially realized appreciation of real estate. As the property owner partially realizes that appreciation by refinancing, increasing, or modifying an existing mortgage, the owner must pay mortgage recording tax.

In paying that tax, however, the owner must go through a series of complex documentational gyrations so they pay mortgage recording tax only on the incremental amount of any mortgage financing. Those gyrations include the following:

- No New York mortgage can ever be paid off or "satisfied." The existing lender must instead "assign" all existing mortgages to the new lender. This requires delivery of all original notes and mortgages, at closing, to the new lender.
- To increase the mortgage debt, the borrower will typically sign a new note and mortgage for the incremental new debt. The new note and mortgage are "consolidated" with the old note and mortgage, then the consolidated documents are "restated" to reflect the new financial terms of the total debt.
- Every step in the mechanism to save mortgage recording taxes must be explained in a "section 255 affidavit," which describes how much (if any) additional mortgage recording tax is due.

These gyrations have a series of adverse effects on New York mortgage closings. They have spawned a weird body of law and procedure that creates extra work and gratuitous and unnecessary pitfalls. Those problems and pitfalls can be summarized as follows:

- In any complex refinancing or loan restructuring, loan documents multiply because of the mortgage recording tax. Up to half the documents in a complex mortgage closing are motivated by the need to minimize mortgage recording tax. Each of those tax-minimization documents — including every section 255 affidavit — must recite, in tedious detail, the entire "chain" of old mortgages, which takes time, consumes paper, and invites mistakes. While no part of this exercise is terribly challenging, it requires time, trouble, and effort — hence expense.
- When a loan is being refinanced, the old lender must deliver all original notes and mortgages at closing. This requirement produces scenes that would be comical if they were not serious. The old lender drags into the closing a pile of old paper, sometimes dating back half a century. The new lender and the title com-

pany then laboriously check through the pile to make sure every note and mortgage is included. Again, this Dickensian process is not terribly challenging, but it takes time and creates complexity.

- If the old lender, the "assigning mortgagee," cannot locate one of the old note(s) — a problem that occurs surprisingly often — then lender's counsel needs to prepare affidavits accounting for the absence. If the assigning mortgagee is not creditworthy (e.g., a private individual who took back paper on a sale), then their inability to deliver the original note and the need for them to deliver a lost note affidavit can create substantive issues that can actually threaten closings.

- If a property owner by mistake allows a mortgage to be "released" for a split second — even if they intended to merely refinance it — then they "lose" any credit for mortgage recording tax previously paid. They must pay the tax again, from the first dollar of indebtedness. This rule, reaffirmed in a very recent mortgage recording tax ruling, is purely a vicious trap for the unwary. It appears to be based on no apparent considerations of tax policy or fairness whatsoever.

- In a series of hypertechnical rulings, state officials have concluded that a "revolving" loan incurs a new mortgage recording tax every time the borrower reborrows any funds. Because of the incompatibility of this concept with the modern financial world, New York real property simply cannot be used to secure revolving loans, unless the parties go through documentation gyrations even more weird than those described above.[1] The law was, of course, recently changed to facilitate revolving loans of under $3,000,000.[2] The Legislature seems to believe that: (a) revolving loans of $3,000,000 or more should for some reason continue to be severely disincentivized and (b) anyone making or borrowing such loans of $3,000,000 or more will actually secure them with New York real property and pay the resulting tax on readvances. The legislation by no means solves the "revolving loan" problem for all commercial mortgages. It actually introduces a new layer of complexity arising from typical concerns about aggregation of multiple transactions.[3]

- Even a routine mortgage assignment — a document requiring very little legal analysis in most states — in New York can require delivery of a separate affidavit and create mortgage recording tax issues.

- In foreclosing a New York mortgage, many lenders believe they need to account for all the "ancient" notes and mortgages they hold, which adds complexity and volume to foreclosure papers, and expense to a process that is already more complex, slow and expensive than in most other states. Missing documents may allow borrowers to raise spurious defenses.

These problems all arise from the formalism with which the mortgage recording tax has been interpreted. Formalistic requirements have produced formalistic, paper-intensive procedures. As a result, mortgage closings in New York suffer from gratuitous complexity almost unheard of anywhere else in the country. That gratuitous complexity probably doubles the attorneys' fees for many New York mortgage closings. Although a doubling of attorneys' fees may in the abstract sound like an excellent concept, most attorneys — including the author of this proposal — would probably prefer doing work that adds value rather than generating complex paper that serves no substantive purpose.

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The state can and should cut away the entire morass of weird documentation that has grown up around the mortgage recording tax. This can be done without changing the fundamental structure of the tax at all or adversely affecting state revenue. The state simply needs to allow borrowers and lenders to forget about the formalistic mechanics of mortgage documentation and instead focus on the fundamental basis for the tax.

The mortgage recording tax is a one-time tax on conversion of unrealized appreciation of real estate into mortgage financing. It should therefore be imposed, collected and tracked based on precisely that measure and nothing more.

Whenever a borrower records a mortgage or increases the total amount of mortgage debt on a property, the borrower should simply pay a tax on the amount of the mortgage or the increase — without any need to suffer through mortgage assign-

ments, "gap" notes or mortgages, consolidations, severance agreements, "substitute mortgages," affidavits ad infinitum, or any other of today's mortgage recording tax gyrations.

A simplified mortgage recording tax could be calculated, assessed, and paid with a one-page tax return that a borrower would submit with any mortgage-related document when recording it. The tax return would set forth only the following information:

(a) The amount of unrealized appreciation previously taxed for the same real property, with recording information for the last mortgage. One might call this variable the "Tax-Paid Loan Value" of the property.

(b) Today's increase in mortgage debt (call this the "New Debt").

(c) The mortgage recording tax now payable (call this the "New Tax"), based on the New Debt.

As soon as the borrower paid the New Tax, the Tax-Paid Loan Value for the property would rise by the amount of the New Debt. When the borrower refinanced the same property again, they would file an updated tax return, starting from the Tax-Paid Loan Value after the first transaction. Over the years, the Tax-Paid Loan Value of any property would increase as New Tax was paid.

To further simplify the mortgage recording tax, one could do away completely with the need for a tax return. Instead, the same information, in a standard format, could appear on the cover page of every mortgage or mortgage amendment.

An old mortgage could be released, and a new one recorded, without losing Tax-Paid Loan Value from earlier mortgages. Borrowers and lenders would no longer need to waste time with mortgage assignments, consolidations, amendments, or restatements, or parsing through piles of historical paper to account for all the old notes. The release of a mortgage — as opposed to its amendment and restatement — should not cost a borrower money by changing the imposition of a tax that fundamentally applies to unrealized appreciation of real estate.

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The Tax-Paid Loan Value of any property would stay constant even if a loan were repaid. A borrower could repay and reborrow, up to the maximum Tax-Paid Loan Value, without paying repetitive mortgage recording tax. New York real property would become available to secure revolving commercial loans above $3,000,000. It is difficult to believe that the state collects much revenue today from repetitive taxation of commercial mortgages that secure revolving loans above $3,000,000. Therefore, the abolition of this principle of repetitive taxation should cost the state no significant revenue. It might actually increase revenue by inducing corporate multi-state borrowers to record mortgages in New York that simply are not recorded today.

If a mortgage were foreclosed, the Tax-Paid Loan Value of the affected property could either drop back to zero, as under existing law, or remain intact.

Preservation of Tax-Paid Loan Value after a foreclosure might look like a gift to the real estate community. In practice, however, actual completed foreclosures are quite rare. Moreover, settlements of defaulted loans are usually structured to "preserve" tax-paid mortgages for future financings. Because it can be done, it usually is done. This often produces complexity driven purely by mortgage recording tax considerations and artificially creates leverage for borrowers in default. The goal of any change in the tax should be to eliminate the need for gratuitously complex documentation at any stage in the life of a mortgage loan. Finally, foreclosure hardly seems an event that should trigger incremental tax revenues. On balance, the author would favor disregarding foreclosures in determining subsequent Tax-Paid Loan Value. This is not a central issue in any simplification of the tax.

The first concern of any tax official contemplating a simplified mortgage recording tax will be enforcement: How can the state assure that borrowers pay the right mortgage recording tax, whether they submit one-page tax returns or provide the same information on the cover page of a mortgage? A tax official would argue that the current regime provides a clear trail, and affidavits, to allow recording officers to make sure borrowers pay all the mortgage recording tax they owe.

A simplified mortgage recording tax would actually be easier to enforce, not harder, than the existing scheme. Under the simplified tax, a borrower would provide recording information for the last prior mortgage that increased the Tax-Paid Loan Value of their property. The recording officer would merely need to look at that prior mortgage, confirm the borrower's statement, and proceed. The recording officer would no longer need to cross-check "chains" of old mortgages or understand and think through complex documentation schemes driven solely by mortgage recording tax considerations.

If a borrower wanted to commit fraud or perjury (by signing under oath a legal document that would be part of the permanent records of the recording office and hence permanently available as evidence, of the highest quality, in a prosecution), they would have the same opportunities under the "old" and the "new" mortgage recording taxes.

As a further cross-check, the simplified mortgage recording tax could require that the lender or the title company insuring the transaction join in the mortgage recording tax return, or countersign the tax calculations on the cover page of the mortgage.

Finally, in simplifying the mortgage recording tax, the state might want to increase the lender's and the title insurance company's economic incentives to "police" the payment of mortgage recording tax.

Today, if a borrower does not pay enough tax, the lender's foreclosure action is limited to the principal amount for which correct tax was paid. But the lender or title insurance company can correct an underpayment at any time before foreclosure, by paying the unpaid tax with interest. This arrangement makes it relatively easy and inexpensive to try to get away with underpaying the tax.

In practice, lenders and title insurance companies do not seem to rely on their option to "pay up" before foreclosure. Instead, they do a reasonably good job of policing the payment of mortgage recording tax at closing, even under the existing weak incentive structure.

The state could, however, make it harder to correct underpayments after closing, by increasing the interest rate or attaching a larger penalty to the underpayment, such as 200% of the underpayment.

Any of these changes would amply counteract any incremental risk of underpayment that might arise from a simplified mortgage recording tax. Lenders and title insurance companies would, even more than they already do, make sure that the borrower pays all mortgage recording tax due.

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Regardless of the exact structure of a simpler mortgage recording tax, it would, with no material cost or effort, dramatically streamline most mortgage transactions in New York, and produce the following public benefits:

- New York real property would become more easily, cheaply and quickly financeable and hence, indirectly, to some degree more valuable.
- New York real property would become readily available to secure revolving commercial loans of $3,000,000 or more.
- The state may be more likely to see an increase in mortgage recording tax revenues than a decrease.
- The state would remove a purposeless burden on real estate financing transactions, thus making it easier to do real estate business in New York.
- New York title searches and reports would become simpler to prepare and understand.
- Mortgage recording tax simplification would be another concrete and easy way to show that government and taxes in New York State do not necessarily have to be more complicated, difficult and burdensome than in any other state.

Compelling reasons exist to simplify the mortgage recording tax. The simplification proposed here would truly achieve such a simplification — without piling on new complexities. It is difficult to see any compelling reason not to simplify the mortgage recording tax.

Endnotes

1. *See* Stein, J., *New York Mortgage Recording Tax on Revolving Loans: The Problem and a New Solution for Multistate Transactions*, 22 New York State Bar Association Real Property Law Section Newsletter 13 (Winter 1994). This article also describes the workings of the mortgage recording tax in greater detail, as well as a way around the "revolving loan" problem in some but not all multistate transactions.
2. 1996 New York Session Laws Ch. 489 and 490 (effective November 6, 1996).
3. *See* New York State Department of Taxation and Finance Technical Services Bureau Memorandum TSB-M-96(R) (October 24, 1996), reprinted at 5 CCH New York State Tax Reporter ¶ 300-210 (pg. 40,448). The statute does not provide for aggregation of this type, but the Department of Taxation and Finance memorandum does.

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