Potential implications of proposed mezzanine tax: Consequences for lenders and developers - by Rachel Orbach and Meghan O’Reilly

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As the real estate industry continues to grapple with the effects of rent reform, new legislation was introduced last month to the New York State Legislature that stands to create further confusion and unintentionally wreak negative consequences on developers, owners, and renters alike. The mezzanine tax—recently proposed by senator Julia Salazar and assembly member Harvey Epstein—would require the payment of a mortgage recording tax in connection with mezzanine debt

at the time of recording a related mortgage, and that the taxes collected would be used specifically to fund public housing.

This would have the most direct impact on property owners, by increasing their cost of financing and consequently hiking costs for residential and commercial renters and buyers in New York. In addition, the uncertainty of the language used in the bill creates potential loopholes and ambiguities that will severely dilute its efficacy and/or cause it to be applied to non-mezzanine debt. As the industry deals with a number of unexpected consequences of rent reform, we urge the legislature to not move ahead with the mezzanine tax without conducting a complete analysis of the underlying rationale, market and appropriate drafting language.

Perhaps the most significant issue with the new legislation is that costs will likely trickle down to New York residents renting or buying an apartment, as well as businesses renting or purchasing office space in the city. In the event that tax revenue is needed for public housing purposes, it is unclear why imposing a tax on mezzanine debt, a tax that will be passed on to all consumers, is the appropriate mechanism for raising such funds rather than engaging in the normal budgetary process. The public should not be misled into believing that taxing mezzanine debt to pay for public housing is a proxy for a wealth tax. It's reasonable to assume that, in reaction to this legislation, the market will restructure what would otherwise be mezzanine debt as preferred equity. There is no public policy in favor of creating such an incentive and in that case, even with the most conservative terms possible, there is still the potential for increased real estate financing costs.

Additionally, there are a number of technical questions that need to be addressed before a mezzanine tax would become fully operational. In the real estate market, mezzanine debt is understood as debt secured by the direct or indirect equity interests in a property owner. In the proposed bill, mezzanine debt is defined as "debt carried by a borrower that may be subordinate to the primary lien and/or common shares." This new definition is broad, unclear and may inadvertently capture corporate debt, tax structuring debt, debt secured by co-op interests and other financing, which is not mezzanine debt as the market understands it. Inadvertent taxation of other types of debt increases the costs of such debt and can have unintended consequences in the types of businesses and individuals with access to debt as well as certain types of foreign investment.

For this bill to become operational, the language of the legislation should be refined to adequately address how mezzanine loans work in practice. The legislation requires that the mezzanine debt relating to a property be "filed" in connection with the recording of a mortgage on such property at the county level. Currently, the only filing made with respect to a typical mezzanine loan is a Uniform Commercial Code Financing statement at the state level, which requires information that may be different from mortgage filings.

Mezzanine debt may or may not be incurred at the same time as a mortgage, and the language of the bill leaves open the possibility that filings and payments of the related tax would only be required at the time a mortgage was filed on the property. If this is permitted under the final wording of the statute, it would be very simple to stagger the timing of all or any portion of the mortgage loan and the mezzanine loan so as to avoid this additional tax – eliminating the efficacy of the bill in the first

place.

We encourage the New York State Legislature to thoroughly consider this issue from all angles before moving forward with legislation to pass the mezzanine tax into law. With mortgage recording tax already an existing tax burden on real estate financing in New York, it's unclear why mezzanine debt – out of all the many types of commercial and consumer debt – is being arbitrarily singled out for additional taxation. We urge lawmakers to take a comprehensive view of this topic and develop nuanced legislation that benefits all stakeholders of real estate transactions in New York City.

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