

# FEDERAL STANDARD ABSTRACT TITLE NEWS

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## Q&A - WRAPAROUND MORTGAGES AND SUPPLEMENTAL MORTGAGES

On November 18, 2004, important changes to Articles 11 & 22 of the Tax Law became effective. These changes affect how mortgages are used to facilitate real estate transactions involving properties within the New York City. To help better understand the new law, the New York State Department of Tax and Finance has issued the following Q & A:

### WRAPAROUND MORTGAGES

Section 250(2) of the Tax Law was amended to require that mortgage recording taxes (MRT) be paid on the recording of a mortgage on the city of New York securing indebtedness the proceeds of which are used to reduce the equity of the holder of a wraparound mortgage or similar mortgage, regardless of whether the indebtedness secured by mortgage on the property is increased or added to.

Q1. *What is a wraparound mortgage or similar mortgage for purposes of the new law?*

A1. A wraparound mortgage or similar mortgage is a mortgage that provides that the indebtedness secured by the mortgage lien includes the outstanding principal balance of one or more other mortgage debts, which maybe referred to as the first or underlying mortgage or mortgages. The mortgage need not be identified as a wraparound mortgage provided the requisite incorporation provisions are present. In a wraparound mortgage, there are two or more separate loans secured by mortgages on the property; the underlying mortgage loan or loans and the wraparound mortgage loan. Although the principal amount of the underlying mortgage loans is included in the principal amount of the wraparound loan, there are separate lenders and separate obligations. The holder of a wraparound mortgage generally collects the principal and interest on the wraparound mortgage loan, makes the principal and interest payments in the underlying mortgage loans, and is entitled to keep any excess.

Q2. *What is the equity of the wraparound mortgage holder for the purposes of the new law?*

A2. The equity of the wraparound mortgage holder is that portion of the principal amount of the wraparound mortgage debt that represents new or further indebtedness or obligation in excess of the outstanding principal balance of any underlying mortgage "wrapped" by the wraparound mortgage. The holder of a wraparound mortgage can reduce his equity position to cash by refinancing the underlying mortgage or through anew financing. In a typical transaction, the holder causes the wraparound mortgagor to take out a new mortgage loan the proceeds of which are paid to the holder of the wraparound mortgage. The holder of the wraparound mortgage subordinates his mortgage in the amount of the new mortgage loan. The new mortgage is not substituted for the wraparound mortgage, and both debts remain outstanding after refinancing. The New York State Tax Appeals Tribunal and the courts view such transactions as a substitution of one debt for another. That result does not reflect the separate nature of the debt secured by the wraparound mortgage and the debt secured by the underlying mortgage. The new law is intended to overturn those decision to the extent indebtedness secured by mortgages on the property is used to reduce the wraparound mortgage holder's equity position.

### SPREADER MORTGAGES

Section 255(1)(a) was amended to designate the existing provisions as subparagraph (1) and to add new subparagraph (ii). The new provisions in subparagraph (ii) are intended to preclude the avoidance of the mortgage recording tax in the city of New York on the recording of an instrument that secures a new indebtedness by spreading the lien of an existing mortgage on real property owned by one person to real property owned by another person in connection with a release of the first property from the lien of the existing mortgage and a release of the owner of that first property from any obligation under the indebtedness secured by that recorded primary mortgage.

Q3. *What is meant by an additional mortgage for purposes of subparagraph (ii) of Section 255(1)(a)?*

A3. The phrase spreading agreement or additional mortgage (herein collectively, a "Spreader") refers to (i) any modification to an existing mortgage that spreads a lien of such existing mortgage to another property and (ii) any modification to an existing mortgage whereby in either (i) or (ii), the original obligor/mortgagor and its property are released

from the obligation and mortgage and a new obligor/mortgagor is substituted for the original obligor/mortgagor and the new obligor/mortgagor's property becomes the collateral under the mortgage.

Q4. *What is meant by real property described in or originally covered by the recorded primary mortgage for purposes of subparagraph (ii) or Section 255(1)(a)?*

A4. Real property described in or originally covered by the recorded primary mortgage as security for the mortgage includes real property, as contemplated by Section 250(1) of the Tax Law, described by metes and bounds, block and lot, street address or other method commonly used in real property transactions. In addition, real property and interests therein covered by clauses contained in the original recorded primary mortgage such as "all right, title and interest, if any, of the mortgagor in and to the mortgaged premises and all rights appertaining to the use and enjoyment of the mortgaged premises," following any such property description will also be considered to be described in or originally covered by the recorded primary mortgage. Moreover, real property included in the security for a mortgage under an after-acquired property clause or blanket mortgage will be considered to be described in or originally covered by the recorded primary mortgage for this purpose.

Q5. *What is the definition of the mortgagor of the real property covered by or described in the recorded primary mortgage?*

A5. For purposes of subparagraph (ii), real property not covered by or described in the recorded primary mortgage will be considered owned by the mortgagor of the real property subject to the lien of the recorded primary mortgage if the title owner of the new property is the title owner of any real property, or interest therein, covered by or described in the recorded primary mortgage. (But see Q&A 6-8 regarding transfers for tax avoidance purposes, and Q&A 9 describing transactions that are not intended to be covered by the new amendment.)

Q6. *When will a transferee of real property be considered to be related to the transferor/grantor of real property for purposes of the presumption that a transfer tax is for avoidance or evasion purpose under subparagraph (ii)?*

A6. In accordance with Tax Law Section 253-a, the following persons will be considered to be related to the transferor/grantor for purposes of the presumption:

-members of a family, including spouses, ancestors, lineal descendants, and brothers and sisters (whether by whole or half blood);

-a shareholder and a corporation where more than 25% of the value of the outstanding stock of such corporation is owned or controlled directly or indirectly by such shareholder;

-a partner and a partnership where more than 25% of the capital or profits in such partnership is owned or controlled directly or indirectly by such partner;

-a beneficiary and a trust where more than 25% of the beneficiary interest in such trust is owned or controlled directly or indirectly by such beneficiary;

-two or more corporations, partnerships, associations, or trusts, or any combination thereof, which are owned or controlled, either directly or indirectly, the same person, corporation or other entity, or interests; and

- a grantor or a trust and the trust.

Q7. *Under what circumstances will the Commissioner of Taxation and Finance view a transfer of property within 12 months of the recording of the mortgage spreader to have been undertaken for a tax avoidance purpose?*

A7. The Commissioner of Taxation and Finance generally will view a transfer to a related party as undertaken for a tax avoidance purpose if the transaction has all of the following characteristics:

-Prior to the transfer, the owner of the real property to be added to the lien of the recorded primary mortgage under the spreader was not related to the owner of the real property covered by, or originally described in, the recorded primary mortgage, within the meaning of Tax Law Section 253-a92)(b), substituting 25% for 50% where it appears,

-The related party is intended to dispose of its ownership of one or more of the parcels of real property shortly after the spreader transaction is completed subject to the lien of the spread recorded primary mortgage,

-The real property originally covered by or described in the recorded primary mortgage is to be released from the lien of the recorded primary mortgage as part of the spreader transaction and the debtor under the indebtedness secured by the recorded primary mortgage is to be released from all obligations to repay that indebtedness as part of the same transaction.

Q.8. *What are the consequences if the Commissioner of Taxation and Finance disregards a transfer of property in connection with the recording of a spreading agreement as having been undertaken for a tax avoidance purpose as described in subparagraph (ii) of Section 255(1)(a)?*

A8. If the Commissioner of Taxation and Finance, or his or her delegate, concludes that one or more of the properties to be covered by the spreader was transferred to the mortgagor for the purpose of avoiding the application of Tax Law Section 255(1)(a)(ii), in determining whether the property to become subject to the lien of the spread mortgage is owned by the mortgagor of property described in or originally covered by the recorded primary mortgage, the Commissioner of Taxation and Finance will consider the person that transferred the property to the mortgagor to be the owner of the property for purposes of subparagraph (ii). If the transferor is not the mortgagor of the property described in, or originally covered by, the recorded mortgage, subparagraph (ii) will apply, and subject to Q9, below, will require the MRT to be paid on a recording of the spreader.

Q9. *What types of transactions are not intended to be subject to tax under subparagraph (ii) of paragraph (a) of subdivision 1 of Section 255?*

A9. Notwithstanding the provisions explained in A7 and A8 above, the provisions contained in Tax Law Section 255(1)(a)(ii) are not intended to adversely affect the recording of mortgages spreading agreements or additional mortgages undertaken for legitimate business purposes, such as the following transactions:

- The recording of an instrument extending the lien of the recorded primary mortgage to cover new leases, new improvements, new construction or additional interests, such as easements, on the property described in or originally covered by the recorded primary mortgage.
- The recording of an instrument to sever and modify the lien of the recorded primary mortgage to reflect a declaration of condominium ownership or subdivision of the real property.
- The recording of an instrument to sever and modify the lien of the recorded primary mortgage to reflect the replacement of construction financing with permanent financing.
- The recording of an instrument to spread the lien of a recorded primary mortgage covering real property to be exchanged in a transaction qualifying for non-recognition of gain under Section 1031 of the Internal Revenue Code to the real property to be acquired by the mortgagor in the qualifying exchange.
- The recording of an instrument to spread the lien of a recorded primary mortgage where the real property to be added to the lien is owned by a person related to the mortgagor of the recorded primary mortgage within the meaning of Tax Law Section 253-a (using a 50% test of ownership), provided that the original mortgagor/obligor is not released from the debt instrument secured by the mortgage.
- The recording of an instrument to spread the lien of a recorded primary mortgage to cover property owned by an unrelated party that has agreed with the mortgagee to provide additional collateral for the indebtedness of the original mortgagor, provided that the original mortgagor/obligor is not released from the debt instrument secured by the mortgage.

### **NEW YORK CITY REAL PROPERTY TRANSFER TAX (“RPTT”)**

The New York City Department of Finance (the “Department”) deems the transfer of more than one condominium or cooperative unit between the same parties to be a “bulk sale” and applies the commercial RPTT rates instead of the lower residential rates. For a discussion of the application of the transfer tax to multiple units and exceptions allowed by the Department, see “New York City Transfer Tax on Multiple Residential Cooperatives and Condominiums,” posted on the internet at <http://www.titlelaw-newyork.com/MultipleUnits.pdf>.

**\*\*\*SAVE THE DATE \*\*\***

Celebrate with us at the FSA Annual Dinner! Look for your invitation in the mail soon!

**Date:** Friday, February 18, 2005  
**Time:** 6:30 PM  
**Place:** Sheraton LaGuardia East Hotel (Ball Room)

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