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New York State Legislature Poised to Pass New Tax on Real Estate Debt Financing

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The New York State Legislature appears set to enact into law a new tax on debt financing for commercial real estate transactions involving "mezzanine debt and preferred equity investments"[1] located solely in New York City, as part of the 2021-2022 budget.

Although similar bills have failed previously, the current bills appear likely to become law. The proposed law, reflected in both Senate Bill S2509B Pt. SS and the State Assembly Bill A03009B Pt. VV, would require mezzanine debt and preferred equity investments to be recorded and taxed in the same way that mortgages are currently. However, the bill's text leaves a number of important questions open to interpretation, including: whether the bill applies to debt and investments outside the real estate context; whether it would have any practical impact on preferred equity investments; and whether it will be applied retroactively.

The bill is also open to a variety of potential legal challenges, outlined below.

A 2.8% Tax on "Mezzanine Debt or Preferred Equity Investment[s]" Used to Finance Real Estate in New York City

Under the bill, a lender who finances a property subject to a mortgage in New York City[2] must also record "any mezzanine debt or preferred equity investment related to the real property upon which the mortgage instrument is filed."[3] And just as with recording a mortgage, the recording of the mezzanine debt or preferred equity would be associated with a tax. The tax would be levied at the same rate and in the same manner as the tax "on the recording of a mortgage instrument financing statement."[4] Currently, the mortgage recordation tax in New York City on commercial properties is 2.8% of the principal debt. Thus, borrowers from lenders whose interests are in the form of mezzanine debt or preferred equity also would have to pay an additional 2.8% tax against the amount of debt funded under these instruments. All revenue collected from these new taxes would be remitted to the "New York City housing authority."[5]

If a lender holding mezzanine debt or preferred equity fails to record the debt or equity under the new law, or to pay the associated tax, she would lose any "remedy otherwise available" under Article 9 of the Uniform Commercial Code.[6] Remedies under the UCC are the usual route for owners of a debt secured by equity interests in a legal entity to foreclose on such equity collateral in the event of default.

A Lack of Clarity

Many of the details of this new mezzanine debt tax remain unclear due to ambiguities in the bill's text.

Breadth and scope. The bill is drafted to apply to mezzanine debt or preferred equity investment "related to … real property" and secured debt "in relation to real property."[7]

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However, the bill does not define when debt qualifies as “related to” or “in relation to” real property. As such, the new law could be read to cover, and tax, any secured loan made to an operating company that happens to own an indirect interest in a New York City property. Such a broad scope would have profound implications for corporate debt transactions far beyond the world of real estate debt financing. For example, a credit line to an operating company secured by an equity pledge in all of its assets, a small portion of which may include New York real estate, may be subject to taxation under this bill. Among its ambiguities, the bill does not include any allocation of debt that is secured by equity interests in New York City real estate and other assets. Further, it has become customary for mortgage lenders on New York real estate—and in other jurisdictions where there is a lengthy time period to complete a mortgage foreclosure—to require a pledge of equity interests in the mortgage borrower as additional collateral for the loan. It is unclear whether the additional pledge of equity would require payment of a second tax on the same loan where mortgage recording taxes have already been paid.

Retroactivity. Relatedly, the bill is unclear as to whether it seeks to require a lender to pay the recordation tax for mezzanine debt or preferred equity already financed, or whether the tax would only apply to such loan instruments that come about after the bill is enacted into law. However, given the well-established presumption against retroactive legislation, this same lack of clarity makes it likely that a court would construe the bill not to impose a retroactive tax.[8]

Enforceability for preferred equity. As mentioned above, a lender holding mezzanine debt or preferred equity who fails to record would lose remedies otherwise available under Article 9 of the UCC.[9] However, lenders who hold preferred equity investments typically do not pursue UCC remedies in the first place. Rather, because the debt is structured as equity in a joint venture, defaults are treated as breaches of partnership contracts and remedies are governed by partnership and contract law. Thus, it is not clear if the bill would have a practical impact in these cases.

Potential Legal Challenges

As drafted, the bill may be vulnerable to legal challenge on multiple grounds. Notably, any challenge would likely need to be brought in New York State court, not federal court. Under the federal Tax Injunction Act, federal courts may not enjoin “the assessment, levy or collection of any tax under State law” where a remedy is available in the courts of the State.[10]

Vagueness. To the extent that the scope of the bill is materially unclear, as discussed above, it may be open to challenge as unconstitutionally vague, in violation of due process. A statute is unconstitutionally vague when “it fails to give fair notice to the ordinary citizen that the prohibited conduct is illegal, [and] it lacks minimal legislative guidelines, thereby permitting arbitrary enforcement[.]”[11] If expert industry actors are unable to discern which kinds of transactions and investments are subject to the new tax, and different interpretations could include or exclude entire fields of debt transaction, then the bill could likely be said to “fail to give fair notice” and create opportunities for “arbitrary enforcement.”

Retroactivity. If the bill is construed to apply retroactively, it may be subject to challenge under constitutional prohibitions against laws that “impair rights a party possessed when he acted” or which “impose[s] new duties with respect to transactions already completed.”[12]

Contracts Clause. Relatedly, the Contracts Clause of the United States Constitution prohibits any State from “pass[ing] any . . . Law impairing the Obligations of Contracts.”[13] To the extent one reads the bill as weakening a remedy a lender may otherwise have under a preexisting contract, the bill’s new recordation-and-tax hurdle is arguably unconstitutional. With that said, the United States Supreme Court has severely limited the reach of the Contracts Clause.[14]

Tax on intangibles. Under the New York Constitution, Art. 16, § 3, "[i]ntangible personal property shall not be taxed ad valorem nor shall any excise tax be levied solely because of the ownership or possession thereof[.]" The mortgage tax, on which the new bill is based, has been held not to violate this provision because it as "a tax upon the privilege of recording a mortgage," and not a tax on any property itself.[15] However, the new tax is arguably distinguishable from, and not defensible under, this rationale. First, the recording of mezzanine debt and preferred equity investments would be a requirement, not a privilege, under the new bill[16]; and second, the privileges associated with recording mezzanine debt and preferred equity would be far fewer and less significant than those associated with recording a mortgage. On the other hand, the new bill arguably mandates recording only when a mortgage is also recorded; and it arguably would grant UCC Article 9 remedies as a new privilege associated with recording mezzanine debt and preferred equity investment.

Conclusion

Should this bill pass into law—as it seems likely to—the costs associated with financing commercial real estate transactions in New York City would increase substantially. However, the bill's ambiguity in certain key respects leaves open important areas for interpretation and potential legal dispute and challenge.

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[1] N.Y. State S. B. S2509B (2021), Pt. SS, § 1; N.Y. State Assemb. B. A03009B (2021), Pt. VV, § 1.

[2] *See* NYS Senate Bill S2509B, Pt. SS, §§ 1.1, 5.2 (2021) ("Within a city having a population of one million or more . . ."). New York City is the only city in the State of New York with a large enough population for this to apply.

[3] *Id.* at § 1.1.

[4] *Id.* at §§ 5.1–5.3, 5.6

[5] *Id.* at § 7.

[6] *Id.* § 1.4, 5.4.

[7] *Id.* §§ 1.4, 5.4.

[8] *See St. Clair Nation v. City of New York*, 14 N.Y.3d 452, 456–57 (2010) ("It is well settled under New York law that retroactive operation of legislation is not favored by courts and statutes will not be given such construction unless the language expressly or by necessary implication requires it" (internal quotation marks omitted)).

[9] *Id.* at §§ 1.4, 5.4.

[10] 28 U.S.C. § 1341.

[11] *People v. Bright*, 71 N.Y.2d 376, 379 (N.Y. 1988).

[12] *Regina Metro. Co., LLC v. New York State Div. of Hous. & Cmty. Renewal*, 35 N.Y.3d 332, 365 (2020) (quoting *Landgraf v. USI Film Prods.*, 411 U.S. 244, 278-80 (1994)).

[13] U.S. Const., Art. I, § 10, cl. 1.

[14] *See, e.g.*, *Sveen v. Melin*, 138 S. Ct. 1815, 1821 (2018).

[15] *S.S. Silberblatt, Inc. v. Tax Comm'n*, 5 N.Y.2d 635, 640 (N.Y. 1959); *see also Franklin*

Soc. for Home Bldg. & Sav. v. Bennett, 282 N.Y. 79, 86 (N.Y. 1939).

[16] *Compare* N.Y. RPP 291 ("A conveyance of real property… may be recorded") *with* Section 1.1 ("any mezzanine debt or preferred equity investment … shall also be recorded").

Gibson Dunn lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Real Estate Practice Group, or the following authors in New York:

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