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Credit Line Mortgages—And Their Treatment Under New York State Law

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Lawyers involved in the transfer of real property in New York may encounter references to a "credit line mortgage" in numerous documents, including, for example, the State real estate transfer tax form. Many lawyers, however, are not familiar with the definition of a credit line mortgage under the New York Tax Law or with the potential significance of that classification under the New York State mortgage recording tax.

Recent developments in this area that affect the categories of financings with respect to which treatment of the mortgage as a credit line mortgage qualifying under a favorable tax computation provision may be desirable and attainable.

Background

The mortgage recording tax may be a significant element of the costs incurred in connection with any financing to be secured by a mortgage on real property because the applicable tax rate is as high as 2.75% of the maximum principal amount, for mortgages that secure debts of $500,000 or more and that are made with respect to commercial and certain other property in New York City.

Accordingly, significant effort is often expended to minimize mortgage recording tax costs in connection with secured financings. Since the tax is generally paid by the borrower, the borrower and its counsel and title company are typically more motivated than the lender to ferret out any possible savings, either with respect to the transaction at hand or with respect to foreseeable costs of future financings.

Not surprisingly, the most effective approach to minimizing the recording tax in specific circumstances will depend on the purpose and amount of the financing, the type of property which is to secure the financing, and other factors.

The credit line mortgage was devised to provide a straightforward means of obtaining a secured line of credit, the balance of which is expected to fluctuate from time to time, without paying mortgage recording tax more than once on the maximum principal balance of the indebtedness. The reason why a special provision is necessary to reach this common-sense result is discussed below.

Revolving Credit Lines

Under longstanding administrative interpretations of the mortgage recording tax, if a debt secured by a mortgage is paid down and, thereafter, additional funds are then borrowed from the same lender, the later increase in the overall obligation is considered new indebtedness which will result in additional tax upon the recording of an instrument evidencing the advance. It also appears that, in an action to enforce the mortgage, the tax on the additional advance must be paid in order to obtain a judgment or final order.

These rules obviously present a problem in situations where amounts are to be borrowed under a line of credit having a fluctuating outstanding balance, since the lender will want the mortgage to be enforceable at all times for the entire amount due, without the payment of any additional tax. To permit credit line loans to be obtained and maintained by homeowners and owners of smaller residential properties without onerous recording tax consequences, Section 253-b of the Tax Law was adopted in 1985 to provide that, if a mortgage (i) is a "credit line mortgage" as defined and (ii) applies to real property improved by a one-to-six-family owner-occupied residence, the amount by reference to which the tax must be computed is the maximum principal amount specified in the mortgage, with no further tax being due on advances or re-advances to the obligor.

A credit line mortgage is defined for purposes of Tax Law Section 253-b as:

> any mortgage or deed of trust, other than a mortgage or deed of trust made pursuant to a building loan contract as defined in subdivision thirteen of section two of the lien law, which states that it secures indebtedness under a note, credit agreement or other financing agreement that reflects the fact that the parties reasonably contemplate entering into a series of advances, or advances, payments and re-advances, and that limits the aggregate amount at any time outstanding to a maximum amount specified in such mortgage or deed of trust.

In 1996, the credit line mortgage provisions were amended to provide that, if a credit line mortgage applies to property other than a one-to-six-family owner-occupied residence, the same rules regarding calculation of the tax will apply if the mortgage is of an amount less than $3 million. The New York State Senate "Memorandum in Support" for the 1996 legislation confirms that the purpose of the amendment was to broaden the borrowing options available to small businesses by permitting them to obtain and use revolving credit lines secured by mortgages without adverse recording tax consequences.

Several Exceptions

Several exceptions and limitations to the favorable treatment accorded to credit line mortgages on qualifying property should, however, be kept in mind. Some of these limitations are intrinsic to the definition of a credit line mortgage as quoted above.

"Building Loan Contract" Exclusion

A mortgage cannot qualify as a credit loan mortgage if made pursuant to a "building loan contract" as defined in Section 2 of the Lien Law. That section includes a definition of a building loan contract as "a contract whereby a party thereto, . . . , in consideration of the express promise of an owner to make an improvement upon real property, agrees to make advances to or for the account of such owner to be secured by a mortgage on such real property." Other sections of the Lien Law relating to mechanics' liens contain further requirements relating to the form and content of a building loan contract and the consequences of a contract's qualifying or failing to qualify as a building loan contract.

Counsel to a title insurance company recently asked the Department of Taxation and Finance for advice bearing on whether a mortgage loan and related documents would constitute a building loan contract for purposes of the credit line mortgage provisions, and therefore not a credit line mortgage potentially eligible for more favorable treatment. Specifically, guidance was requested with respect to revolving credit financings in which no "formal building loan agreement" (presumably referring to an agreement that meets all the requirements for building loan contracts under the Lien Law) is executed, but the loan documents recite that the funds to be advanced or readvanced will be used either (i) to reimburse the borrower for expenses incurred in making improvements on real property or (ii) to fund such improvements.

The answer received, as set forth in a recent advisory opinion issued by the Commissioner of Taxation and Finance (TSB-A-99(2)R, April 7, 1999), is that recitations of the type stated above in loan documents would suffice to cause the mortgage loan to constitute a building loan contract for this purpose, and therefore to prevent the mortgage from being a credit line mortgage. The opinion also states that the term "building loan contract" must be interpreted for purposes of the mortgage recording tax without regard to the other provisions of the Lien Law relating to required elements of such contracts, because the recording tax provision refers only to the specific paragraph in the definitions section of the Lien Law that defines this term.

Alternative Interpretations

It is unclear whether this advisory opinion reflects the most appropriate interpretation of the "building loan contract" exclusion from the definition of a credit line mortgage. Certainly there are alternative interpretations that are plausible.

Specifically, the clause in the definition of building loan contract requiring that the contract be entered into "in consideration of the express promise of an owner to make an improvement . . ." seems to refer to loans being made by reason of, in whole or in part, the borrower's commitment to use the proceeds to make an improvement.

If a loan agreement does not specify the improvement or improvements to be created or the anticipated cost of the improvements, it is more likely that the lender is making the loan in reliance on factors apart from the intended use of the funds, such as the pre-existing value of the property to be mortgaged to secure the loan and the borrower's creditworthiness. In that event, it is arguable that the loan should not be viewed as being made in consideration of any promise by the borrower to use the funds to make improvements. If the loan was not made in consideration of such a promise, it would not fit within the literal terms of the Lien Law definition of a building loan contract.

It might also be argued, based on a close reading of the advisory opinion, that the conclusion expressed therein would not apply to a mortgage if the related loan documents state that the borrower intends to use the credit line to fund improvements to real property but may use amounts borrowed under the credit line for other purposes.

As a planning matter, the published interpretation of the Department of Taxation and Finance discussed above suggests that documents for a revolving credit line to be secured by a mortgage that is intended to qualify as a credit line mortgage under the mortgage recording tax should not, if at all possible, include any statement that commits the borrower to use the line of credit to fund improvements to real property or to "reimburse" the borrower for funds expended for that purpose.

Other Issues

The Department of Taxation and Finance also issued recently a memorandum (TSB-M-99(1)R, June 25, 1999) addressing other issues relating to the extension of the credit line mortgage provisions to apply to loans secured by property other than a one-to-six-family owner-occupied residence.

Very briefly, the points addressed in the memorandum (and the Department's responses), in the context of credit line mortgages on such other property, include: whether a credit line mortgage for $3 million or more recorded before November 6, 1996, may be amended to qualify as a credit line mortgage entitled to more favorable treatment under the new provision (under the circumstances stated, no); when mortgages by the same borrower or with respect to the same property will be aggregated for purposes of determining whether the less-than-$3 million limit has been exceeded; whether a credit line mortgage of less than $3 million securing a revolving credit obligation of $3 million or more will qualify for the more favorable computation of tax (no); whether a credit line mortgage qualifying under the new provision may continue to qualify (a) if that mortgage is spread to a second property, with the first property being released from the lien immediately before the sale of the first property, or (b) if, in conjunction with the transaction described in (a), the mortgage is assigned to a new lender (yes to both); and whether the qualifying status of a credit line mortgage may be preserved if there is a change in the identity of the borrower (no).

In many respects the TSB memorandum appears to set forth highly restrictive interpretations of the amended rules. One may speculate that the memorandum reflects an effort to permit the amended provisions to be used for secured revolving lines of credit that were previously impractical (because of adverse recording tax treatment) and hence not entered into, while foreclosing, to the greatest extent possible, strategies to use the amended provisions to reduce recording tax costs with respect to other types of financings.

It remains to be seen, of course, whether the views of the Department of Taxation and Finance with respect to the issues highlighted by the advisory opinion and the TSB memorandum will prevail in all respects.

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