Every Penny Counts — Minimizing Mortgage Tax in Commercial Real Estate

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While the economy struggles to distance itself from the trailing impacts of COVID-19, rising interest rates and inflation have made borrowers even more cost-conscious in commercial real estate transactions in the last 18 months or so. Whether it's the increased cost of labor and materials for a construction loan or simply a higher set of closing fees for an acquisition loan, most of these costs are beyond the control of a borrower or lender and are simply a necessary part of the process. However, mortgage tax is one area where a borrower and lender may be able to take some preventive steps to limit its impact on a closing if there is a refinance occurring.

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Pursuant to § 255 of the Tax Law, New York is one of a handful of states that imposes a tax when recording a mortgage at the applicable county clerk's office. The amount of the tax may vary on a county-by-county basis, but here in Erie County it is calculated at 1% of the loan amount that is secured by the real estate. Using a loan amount of $1,000,000 as an example, $10,000 would be due to the county clerk at the recording. Without question, it can be a sizeable and important part of the overall flow of funds, especially when dealing with larger loan amounts.

Luckily for borrowers and lenders, if there is a refinance, the new lender can take the existing mortgage loan by assignment and then consolidate it with a gap mortgage and then a consolidation, modification and extension agreement. Rather than record a new mortgage and pay the tax on the full loan amount, assigning an existing loan to a new lender allows the borrower to get a credit for the tax that was paid on the existing mortgage at the time of the original closing. This results in payment of the 1% tax on only the difference between the current principal balance at the time of the assignment and the new loan amount, commonly referred to as the "gap" or "new money" amount.

For example, if a borrower has an existing mortgage with a current principal balance of $400,000 with "Bank A," but wants to refinance its loan and have it assigned to "Bank B" for a new total loan amount of $1,000,000, the existing $400,000 principal balance is exempt from payment of the mortgage tax (saving $4,000 in closing costs) and can be assigned to Bank B. The new lender would then record a gap mortgage instrument for the difference of $600,000 (payment of $6,000 in mortgage tax instead of $10,000) and then immediately record a consolidation, modification and extension agreement for the full amount of $1,000,000.

Although there is no requirement on a lender to assign its existing mortgage to another party, it is customary for lenders to agree to do so, and sometimes an assigning lender may charge a fee for such an accommodation, typically either a flat fee or a fraction of a percentage of the current balance. In addition, the assigning lender is likely to engage its legal counsel to assist with the assignment process, which can result in additional legal fees a borrower may need to pay at closing. Keeping in mind the savings in Erie County is 1% of the existing principal balance, it is imperative to conduct a cost-benefit analysis to determine if the savings outweighs any assignment fee and/or additional legal fees. In most cases, a borrower and/or its counsel are eager to explore this option, and it has become even more popular as other associated closing costs have continued to rise.

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