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Application of the Mortgage Recording Tax to Breakage Costs Secured Under Interest Rate Swap Agreements

Introduction

This bulletin explains whether the mortgage recording tax applies to breakage costs under an interest rate swap agreement when the agreement is secured by a mortgage on real property.

Interest rate swap agreements

For business reasons, a property owner may obtain a floating interest rate loan from a mortgage lender. One of the ways property owners can protect themselves against rate fluctuations is through the use of interest rate swap agreements, or swaps, that protect both borrowers and lenders against rising and falling rates. The swap agreement converts a floating interest rate into a fixed rate as follows:

> The swap provider (a bank or other financial institution, possibly another department of the same lender) and the borrower each agree to make periodic payments to the other for an agreed period of time based upon a notional amount of principal. No principal changes hands at the start or end, instead, payments are computed based on a theoretical amount which acts as the principal amount. If the floating interest rate on the underlying loan rises above the fixed interest rate stipulated in the swap agreement, the swap provider pays the borrower the difference. If, however, the floating interest rate falls below the fixed interest rate, the borrower must pay the swap provider the difference. When the payments between the parties under the swap agreement are combined with the floating rate payable on the underlying loan, the net amount paid by the borrower will equal the fixed interest rate.

If certain specified events occur, such as the borrower's bankruptcy or failure to perform its obligations under the swap agreement, the agreement may require the borrower to pay breakage costs (the cost of breaking the contract). The swap provider may ask for a mortgage securing the breakage costs, typically on the same real estate secured by the borrower's loan. If the swap provider is the mortgage lender, the same mortgage may secure both the loan and the breakage costs.

Summary of tax provisions and regulations

The mortgage recording tax is imposed on the recording of a mortgage on real property situated within New York. The tax is computed based on the amount of principal debt or obligation which is, or under any contingency may be, secured at the date of execution or any time thereafter by a mortgage.

The term *principal debt or obligation* generally does not include interest payable on the indebtedness secured by the mortgage. Nor does it include *incidental amounts* that may become secured by the mortgage if the mortgagee incurs expenses to maintain and preserve the value of the mortgaged premises, or to protect the validity of the mortgagee's lien. *Incidental amounts* would include, for example, real property taxes paid by the mortgagee, and any charges or assessments that are imposed by law upon the mortgaged premises if the mortgagor fails to pay the taxes, resulting in a default under the mortgage.

Breakage costs are considered incidental amounts, not part of the principal debt secured, and are not subject to mortgage recording tax as long as all of the following conditions are met:

- The breakage costs are included in the mortgage as part of the secured obligation and are defined as "*additional interest."*
- The swap agreement relates to the same loan the mortgage secures and not, for example, another unsecured loan.
- The notional amount of principal under the swap agreement is the same as the principal amount secured by the mortgage.

However, if the breakage costs are quantified in a separate mortgage that secures the breakage costs as a separate and distinct obligation at the date of execution or any time thereafter, those breakage costs are considered principal debt, and the mortgage is, therefore, subject to mortgage recording tax.

In addition, mortgage recording tax is due upon the recording of an instrument capitalizing incidental amounts (including accrued interest) as part of the principal amount secured by the mortgage.

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References and other useful information

Tax Law: Sections 253, 256

Regulations: Section 648.1(1)

Advisory Opinions: TSB-A-02(4)R, HSBC Mortgage Corporation (USA)