Challenging New York State's mortgage recording tax

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For many years, the New York State Department of Taxation and Finance (DTF) has levied recording taxes on mortgage loans made by federal credit unions (FCUs) to their members. New York has done so despite the fact that FCUs are federal instrumentalities and are exempt from state taxation under both the Supremacy Clause of the United States Constitution and the Federal Credit Union Act of 1934, as amended (the FCU Act). This article discusses the mortgage recording tax, FCUs' exemption from taxation and Hudson Valley Federal Credit Union's pending litigation, which challenges the constitutionality and legality of the tax as applied to FCUs.

Background

In 2007, Quartararo & Lois, the attorneys for Hudson Valley Federal Credit Union (HVFCU), began making inquiries at the DTF about the relationship between the FCU Act and New York's mortgage recording tax law. The surprising answer they received from a DTF mortgage tax specialist (who was nearing retirement after almost 40 years at the DTF) was that similar inquiries had been made in 1989, and that the DTF researched the issue at that time and concluded that FCU mortgages were exempt from the tax.

The DTF specialist then put HVFCU's attorneys in contact with the former top mortgage tax technician at the DTF, who said that DTF lawyers and technicians, in a series of memoranda written in or about 1990, concluded that FCU mortgages were exempt from the mortgage recording tax, but that the DTF might continue taxing FCU mortgages on the assumption that FCUs would not pursue the issue. This decision resulted in DTF employees being forced to withdraw their own refund applications for taxes paid on mortgage loans they had received from the State Employees Federal Credit Union (SEFCU).

Quartararo & Lois next sought and received permission from HVFCU's board of directors to conduct its own research on the legality of taxing the recording of FCU mortgages. That research led to the same conclusions that the DTF had allegedly reached almost 20 years earlier. HVFCU then engaged the prominent law firm of K&L Gates LLP, which joined with Quartararo & Lois in commencing the legal action described below. Prior to HVFCU's action, New York's application of its recording tax on FCU mortgages has gone unchallenged in the courts.

The New York mortgage tax

Article 11 of the New York Tax Law provides for the imposition of a tax on each mortgage of real property based on the amount of the debt or obligation secured. Depending on the county where the mortgage is recorded, the tax can range from approximately .75 percent of the mortgage loan amount to over 2 percent of the loan, making New York State's closing costs among the highest in the country. The statute is silent as to whether the lender or borrower must pay the tax (except for the "special additional tax," from which FCUs are generally exempt). The tax is paid at the time a mortgage is recorded, and the statute effectively prohibits the use of mortgages not so recorded. Moreover, under New York's recording statute, unrecorded mortgages are void and unenforceable as against subsequent good-faith purchasers for value.

FCUs' exemption from taxation

As the readers of this article will know, FCUs are member-owned, not-for-profit cooperative associations regulated by the National Credit Union Administration, an independent federal agency. The FCU Act authorized the creation of FCUs "to establish a further market for securities of the United States and to make more available to people of small means credit for provident purposes through a national system of cooperative credit, thereby helping to stabilize the credit structure of the United States." In keeping with this purpose, FCUs are empowered to make mortgage loans to their members.

Three years after passing the FCU Act, Congress amended the Act to exempt FCUs and their property from all federal, state and local taxation except real estate and tangible property taxes—exceptions which have no application to mortgage recording taxes. Congress deemed this tax exemption necessary

because: "[e]xperience with Federal credit unions since the passage of the original act indicates that the taxation of these organizations in a manner similar to the taxation of domestic banks places a disproportionate and *excessive burden on the credit unions.*" This exemption provides in part:

> The Federal credit unions organized hereunder, their property, their franchises, capital, reserves, surpluses, and other funds, and their income *shall be exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial or local taxing authority;* except that any real property and any tangible personal property of such Federal credit unions shall be subject to Federal, State, Territorial, and local taxation to the same extent as other similar property is taxed.

In 1998, Congress enacted legislation that broadened the membership criteria for FCUs. This legislation incorporated Congress' findings that FCUs "continue to serve [their] public purpose"—i.e., "meeting the credit and savings need of consumers, especially persons of modest means"—and are tax-exempt because of that purpose. The findings state in relevant part:

> Credit unions . . . *are exempt from Federal and most State taxes* because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and *because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.*

HVFCU's lawsuit seeks declaratory relief.

Challenging the tax

On May 12, 2009, HVFCU, represented by K&L Gates and Quartararo & Lois, filed an action in the New York State Supreme Court which challenges New York's mortgage tax as applied to FCU mortgages. The action contends that the New York mortgage tax is wholly inapplicable and unconstitutional as applied to FCUs on dual grounds—first, that the FCU Act exempts FCUs and mortgages held by them from tax; second, that FCUs' status as federal instrumentalities renders them immune from such taxation under the Supremacy Clause of the United States Constitution. On these grounds, HVFCU's lawsuit seeks declaratory relief to prevent New York's future taxation of FCU mortgages.

The Defendants—the New York State Department of Taxation and Finance, Commissioner Robert L. Megna, and the State of New York—filed a motion to dismiss the action asserting that it is irrelevant whether FCUs and their property are immune from state taxation because the tax at issue applies only to the "privilege of recording" mortgages, and is usually paid by FCU members as borrowers, rather than by the FCUs themselves. Based on longstanding U.S. Supreme Court precedent, however, HVFCU countered that neither the State's characterization of the tax, nor whether it is nominally paid by mortgagor or mortgagee, changes the fact that the State is unlawfully levying a tax on FCU property (i.e., their mortgages).

The broad implications of this case, which extend beyond New York and potentially impact FCUs in all other states with similar taxes, are evident from the fact that the United States Department of Justice filed an amicus curiae brief in support of HVFCU's position. Similarly, the Credit Union Association of New York, the Credit Union National Association (CUNA) and the National Association of Federal Credit Unions (NAFCU)—organizations which collectively represent hundreds of credit unions in New York and thousands more FCUs nationwide—filed amicus briefs aggressively challenging New York's characterization and interpretation of the relevant law. This impressive collection of amici all stand with HVFCU in calling for an end to New York State's taxation of mortgages granted to FCUs.

On May 14, 2010, the New York State Supreme Court issued a decision granting the Defendants' motion to dismiss on the grounds that the court was "constrained" to follow earlier New York cases holding that the mortgage tax is a tax only on the privilege of recording, rather than on the mortgage itself. HVFCU, its attorneys and amici supporters believe that the decision is erroneous under both state and federal law and should be reversed. An appeal has been filed with the Appellate Division, First Department, and should be scheduled for oral argument in early 2011.

A successful outcome for HVFCU in this case would significantly impact the economic interests and constitutional rights of FCUs throughout New York. Consistent with the Congressionally stated purpose for which FCUs were created, i.e., to "meet[ ] the credit and savings needs of consumers, especially persons of modest means," FCUs could expect to attract many new borrower/members and to make more loans to their existing members. Such a result would be especially beneficial in light of the nation's current economic crisis and the credit crunch afflicting many New Yorkers, especially first-time home buyers and individuals looking to refinance their homes. HVFCU is more committed to this challenge than ever and welcomes the support of other New York FCUs. □

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