

BUREAU OF LAW *Mortgage and Land Deal*MEMORANDUM *A-2*

TO: Commissioners Murphy, Macduff and Conlon

FROM: E. H. Best, Counsel

SUBJECT: In the Matter of the Instrument
executed by Atlantic Cement
Company, Inc. to the Prudential
Insurance Company of America

The issue involved in this matter is whether an instrument designated an "indenture of conveyance of Atlantic production payment" is a mortgage which secured a principal debt or obligation.

The petitioner, Atlantic Cement Company, Inc. (hereinafter referred to as Atlantic) executed and delivered the instrument in question dated January 22, 1964 to the Prudential Insurance Company (hereinafter referred to as Prudential) which was subsequently recorded in the Albany County Clerk's Office. Prudential delivered \$8,000,000 to Atlantic on receipt of the instrument. No tax was paid on the recording of the instrument but a marginal notation was placed on the recorded conveyance by the Albany County Clerk that a recording tax of \$40,000 plus additional tax or interest was considered due in respect to the instrument.

It is the opinion of the hearing officer that the instrument imposes a lien upon and affects the title to real property in the form of limestone in the ground as security for the repayment of indebtedness and is a mortgage within the meaning of section 250 of the Tax Law.

The instrument conveyed as a production payment an undivided 70 percent of limestone together with an easement of ingress and egress. The mechanics of the production payment, as explained by Atlantic's president, is that Prudential purchased an undivided interest of minerals in place and paid the seller in advance for them. The production payment is to be discharged by a payment of a specified amount per ton for minerals used or otherwise sold by Atlantic. The undischarged amount of the production payment is to be increased from time to time by amounts equivalent to interest on the undischarged balance and certain expenses. The formula for discharge of the production payment in the instant matter is arranged so that it will be discharged within four years barring unforeseen market conditions.

The instrument provides that Prudential is to receive repayment of the \$8,000,000 in monthly installments computed

upon limestone used by Atlantic plus an "incremental accrual" computed at the rate of 5 5/8 percent per annum on the undischarged amount of the production payment and reimbursement for taxes and costs paid by Prudential when such taxes and costs are not duly paid by Atlantic. The payment to Prudential is to be free and clear of all mining expenses which are to be born by Atlantic. In event that the full amount of the incremental accrual is not paid when due, the unpaid balance of it is added to and becomes a part of the undischarged amount of the production payment together with any other amount to which Prudential is entitled and which is not received by it and thereafter incremental accruals are to be computed thereon. All taxes on the property are to be paid by Atlantic and if Atlantic does not pay them Prudential is permitted to pay them.

Atlantic agreed to continuously mine the limestone subject to the production payment at its own expense and to pay Prudential specified amounts for limestone taken and introduced into its kilns in the manufacture of cement products during the previous month. Atlantic can sell the limestone to anyone without the consent of Prudential but in that event Prudential is to receive the total proceeds of the sale. Prudential had the right to sell limestone and receive 100 percent of the proceeds of the sale subject to any existing contracts for its sale by Atlantic upon giving Atlantic 90 days notice of its intent to do so. Unless Atlantic defaults in the performance of covenants, Atlantic is to be the sole operator of the limestone quarry and Prudential has no right to go upon the property except for inspection purposes. Prudential's rights and interest in the limestone terminate when the production payment is discharged. Prudential acquired an interest in an estimated 470 million tons of limestone. It was also estimated that the repurchase of and payment for less than 11 million tons of limestone by Atlantic would discharge and terminate the production payment. Upon default by Atlantic of any of its covenants for 30 days Prudential has the option, in addition to all other remedies available to it in law and equity to enforce the covenants to receive payment from any purchaser of the limestone in the amount attributable to Atlantic's interest in it. In addition, expenses incurred to enforce the covenants and costs, expenses, taxes or other amounts which Atlantic has agreed to pay under the terms of the instrument and which Prudential pays shall be reimbursed to Prudential out of the limestone attributable to Atlantic's interest in it with interest at the rate of 6 percent per annum. Prudential's rights under the instrument terminate and the production payment is discharged when it has received the full amount specified in the instrument.

Documentary stamps in payment of the Federal tax on conveyances of real property were affixed to the instrument and cancelled. The holders of the other obligations of Atlantic consented to the execution of the instrument. The purpose of

Atlantic in entering into this arrangement with Prudential was to secure further financing which it needed and to attempt to utilize its tax loss carryforwards for the years 1960, 1961, 1962 and 1963.

Prudential will have no interest in the limestone after receiving the payment of the monies specified in the instrument. Atlantic for "book" purposes calculated its income from its operation of the quarry and cement plant without the monies received for the production payment although for tax purposes it treated the monies as taxable income for 1964.

The taxpayer contended that the instrument was a conveyance of property which consisted of an undivided 70 percent of all limestone in and under and which may be mined from specified properties until Prudential realized \$8,000,000 plus the incremental accrual. It argued that the instrument was not a security instrument and that it was not the intention of the parties to it that it be such. It claimed that (1) there was no principal debt or obligation; (2) that the instrument does not create any lien or security interest; (3) that there was no obligation by Atlantic to pay the \$8,000,000 and incremental accrual; (4) that although Prudential's interest in the limestone terminated after it realized prescribed amounts, it has no recourse or remedy against Atlantic; (5) fee title to the specified interest in limestone was transferred by Atlantic to Prudential; (6) that under Federal law, it was required to pay the Federal documentary tax because the transaction was a conveyance of realty; (7) that the purpose of the transaction was to realize income from the profits on the sale of assets in order to prevent the loss of tax deductions for losses sustained by Atlantic in prior years; (8) that Atlantic treated the amount realized on the transaction as income on its Federal income tax and New York State franchise tax returns; (9) that Prudential treated the transaction as a purchase of mineral rights; (10) that Atlantic was not permitted by previous financing agreements to give a mortgage on its property or incur a further indebtedness, and, accordingly, could not give a mortgage on its property; and (11) that the Tax Department is inconsistent with its prior ruling in relation to a production payment conveyance by Alpha Portland Cement Company.

The fact that an instrument is not in the form of mortgage is not conclusive of its character nor the fact that there is no covenant to repay the debt. A deed although absolute on its face, if given as security only, is a mortgage by operation of law. A mortgage may provide that the mortgagee may look to the property alone for payment and that there shall be no personal liability on the part of the mortgagor. (Section 249, Real Property Law, Mooney v. Byrne, 163 N.Y. 86; Atlantic Trust Company v. Holdsworth, 50 A. D. 623, aff'd 167 N. Y. 532; Gardner v. Scurter, 124 Misc. 832.)

The fact that the taxpayer affixed documentary stamps to the instrument is not relevant in determining if it is a mortgage. Section 43.4361-1(a) of the Federal Documentary Stamp Tax Regulations provides, in part, as follows:

"(3) For the purpose of the tax imposed by section 4361, the determination of what constitutes 'realty' is not controlled by the definition or scope of that term under state law. State law determines the character of the rights conveyed by an instrument but whether such conveyance constitutes a conveyance of 'realty' is to be determined under federal laws."

Treatment of the transaction under the Federal Income Tax Law and New York Franchise Tax Law does not control its treatment under the New York Mortgage Tax Law. State law controls the operation of the Federal Tax Law only when it is expressly or by necessary implication made a dependent on the State law (Burnet v. Burnet, 287 U. S. 103). Ortiz Oil Co. v. Commissioner, 102 F. 2d 508 cited by the petitioner to support its agreement that the transaction was a sale of limestone and not a mortgage is not relevant. That case involved the question of an application of Federal income taxes. Further the facts in that case are clearly distinguishable from the facts in the instant matter.

The petitioner contends that R. H. Macy & Co. v. Bates, 280 App. Div. 292 is authority for its position that the mortgage tax cannot be applied in the present case. The R. H. Macy case involves a sale and leaseback of real property. The transaction there was held not to constitute a mortgage of real property since the lease payments did not reduce the cost of repurchase. It has no relevancy here other than for the proposition that if there is no mortgage the petitioner is not liable for the tax.

The petitioner's contention that its intent to give a mortgage because it was prohibited by covenants in its prior loan transactions to give a further mortgage has no merit since the petitioner obtained consent from its obligees to the instant transaction.

Taxpayer's contention that the hearing officer's position is inconsistent with the one he took with regard to the Alpha Portland Cement Company is without merit.

It appears that the Alpha Portland Cement Company executed and delivered to Bmal Corporation an instrument designated "Conveyance of Seven Separate Production Payments" which provided for the conveyance of mineral in the ground until Bmal is paid \$2,900,000 with "Incremental accruals at the rate of 5% per annum

with accumulated expenses." The instrument was held to be a mortgage and subject to the mortgage tax to the extent that the debt was secured by a mortgage or real property located in the State. Eml was a special purpose corporation which served only as a medium of financing. It was contemplated that Eml would borrow most or all of the price of the production payments and mortgage the production payments as security for these borrowings. Eml assigned or mortgaged the production payments to the Chase Manhattan Bank. This latter instrument was not held subject to the mortgage tax. If it could be deemed a mortgage and not an assignment of the existing mortgage, it was at most a mortgage of the production payments and not any part of the underlying realty. A mortgage of production payments is a mortgage of intangible personal property and not subject to the mortgage recording tax. See Belfang v. Belfang, 252 App. Div. 453 aff'd 278 N. Y. 563.

In summary, I am in agreement with the hearing officer that the instrument is a mortgage, which secured the repayment of \$8,000,000 and provided for the payment of interest at the rate of 5 5/8 percent per annum plus additional charges in the event of a default by the petitioner. The value of the limestone securing the debt or obligation far exceeded the amount of the debt or obligation. There is a provision for a defeasance of Prudential's interest in the limestone. Atlantic retained possession of the property and was required to pay all taxes on the property. The main purpose for entering into the transaction was to obtain further financing for Atlantic which it needed in its operations.

In National Bank of Tulsa v. Kansas, 177 Kan. 281, 279 P. 2d 262, a production payment was held to be a mortgage where the statutory definitions of "Real Property" and "Mortgage" are similar to their definitions under section 250 of the Tax Law. A copy of that decision is attached hereto.

If you agree with me, please sign the order and return the entire file to the Law Bureau for further disposition.

/s/

E. H. BEST

Counsel

FVD:ac
Enc.

September 22, 1967

STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE
BEFORE THE STATE TAX COMMISSION

Case No. _____

In the Matter of the Instrument executed by _____ :

ATLANTIC CEMENT COMPANY, INC. _____ :

ORDER

to _____ :

PRUDENTIAL INSURANCE COMPANY _____ :

_____ :

A PROCEEDING having been instituted pursuant to Section 251 of the Tax Law to review the act of the recording officer of Albany County in recording the instrument called "Indenture of Conveyance of Atlantic Production Payment", dated January 22, 1964, executed by Atlantic Cement Company, Inc., hereinafter called "Atlantic", to Prudential Insurance Company, hereinafter called "Prudential", the determination of the recording officer, if any, and the application of Article Eleven of the Tax Law thereto; said instrument having been recorded in the office of the recording officer of Albany County on January 22, 1964, in Book 1782 of Deeds, at page 467; and

PURSUANT TO NOTICE duly given, hearing having been held before Samuel Lorvan, Hearing Officer, designated as such by this Commission, at the office of the State Tax Commission, State Office Building, 80 Centre Street, New York, New York, on May 11 and 12, 1966, and Atlantic having appeared by Sullivan & Cromwell, Esqs., (Kendyl K. Monroe, Esq., of counsel), and DeGraff, Foy, Conway & Holt-Harris, Esqs., (John T. DeGraff, Esq., of counsel), and Prudential having appeared by Donald G. Schenk, Esq., its Associate General Solicitor; and a report having been made by said Hearing Officer;

NOW THEREFORE after examination of the record, the proofs

and various documents submitted in the proceeding and the report of the Hearing Officer and after due deliberation, it is

DETERMINED BY THE COMMISSION

(1) The report of the Hearing Officer dated July 5, 1967, be and the same hereby is adopted.

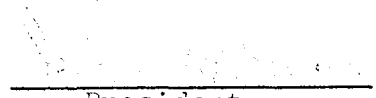
(2) The determination of the recording officer of Albany County made at recording be and the same hereby is cancelled and annulled.

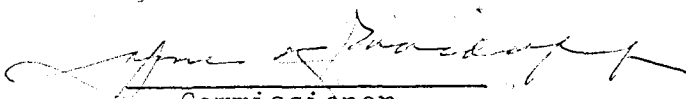
(3) The instrument called "Indenture of Conveyance of Atlantic Production Payment", dated January 22, 1964, imposes a lien upon and affects the title to real property in the form of limestone in the ground as security for the repayment of indebtedness and the performance of contract obligations in connection therewith, and is a mortgage of real property within the meaning of Section 250 of the Tax Law.

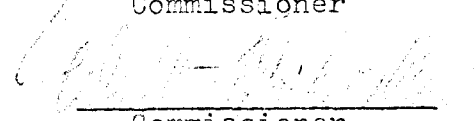
(4) Said instrument was subject at recording to mortgage recording tax of \$40,000 computed pursuant to provisions of Section 253 upon maximum principal indebtedness in the amount of \$8,000,000 secured thereby; and that additional tax is due pursuant to Section 258, computed thereon at the rate of one half per cent per month or fraction of a month from the date of record to the date of payment of the tax.

ADOPTED September 29, 1967

STATE TAX COMMISSION


President


Commissioner


Commissioner