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RECTIFYING THE TAX TREATMENT OF SHARED APPRECIATION MORTGAGES*

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Abstract

The current mortgage crisis has increased interest in innovative shared appreciation mortgages (SAMs). The lender accepts a lower fixed interest rate under a SAM in return for a share of the appreciation -- or value -- of the home over time. SAMs have attracted much recent interest due to their improved (i) spreading of the loss risk across the financial system (thereby reducing the chance of a borrower default when home prices fall), and (ii) correlation of payment timing with the typical lifetime earnings cycle (i.e., lower mortgage payments earlier in one's career).

Unfortunately, the current tax rules make it essentially impossible to develop SAM markets in the U.S. The tax rules for debt instruments with contingent interest generally require both the borrower and lender to report contingent interest each year as if the instrument bore a market rate of (higher) fixed interest. These rules are tax neutral for most instruments, since both the borrower and lender account for the additional contingent interest at the same time. These contingent debt tax rules are not neutral, however, in the case of SAMs since a special earlier-enacted, and unrelated, provision defers the homeowner's interest deductions until payment. The interaction of the two sets of unrelated rules provides an asymmetric result of annual lender inclusions with deferred homeowner deductions. This adverse timing asymmetry can impose a significant net tax cost that makes SAMs extremely unattractive. Curiously, SAMs issued in connection with a workout -- rather than upon original home purchase -- are not subject to this timing asymmetry since the workout lender does not have to accrue the contingent interest each year. The uniquely punitive treatment for original-issuance SAMs therefore seems quite accidental, especially given the lack of any coherent justification for such singling out. And beyond the negative timing asymmetry and inexplicable line drawing, additional tax concerns arise due to uncertainty in reaching definitive tax results (e.g., threshold uncertainty over whether a SAM should even be treated as debt for tax purposes).

In light of the foregoing, we consider three different reform proposals that could remove the tax impediments to the SAM markets: deferral of the lender's contingent interest inclusions; acceleration of the homeowner's contingent interest deductions (to match the lender's annual inclusions); or treatment of the SAM as equity, rather than debt. While all three of these alternatives would eliminate the current poor treatment of original-issuance SAMs, we strongly believe that the best of the alternatives is the first. As discussed in greater detail in the Article, this approach is relatively easy to implement through very limited regulatory changes, can be structured to have little or no consequences outside this narrow setting, and works well for both original-issuance SAMs and workout SAMs.

I. INTRODUCTION

If current trends continue, today's default crisis will shortly be followed by a "lock-out" crisis induced by tightened lending standards. The homeownership rate will fall to levels not seen in decades as an ever increasing number of American households find themselves unable to transition to homeownership. In light of these crises, there is increased interest in efforts to reform the institutions of housing finance, many of which originated in the aftermath of the Great Depression.² In particular, the possible value of innovative shared appreciation mortgage (SAM) markets has been raised to the fore in the context of the current default crisis, as well as in the context of housing affordability.³ In early 2007, Caplin, Carr, Pollock and Tong [2007] (henceforth CCPT) provided a ballpark estimate that introduction of these mortgages would raise the homeownership rate by somewhere in the 0.5%-2.0% range. In the current context it may slow the rate of decline by an equivalent amount, and thereby soften the lock-out crisis. In addition to cutting costs, SAMs provide households with a certain amount of insurance against house value fluctuations. The cost of such equity finance to the homebuyer is low precisely when housing provides low returns, so that such relief is needed. This suggests that past availability of such finance would have substantially mitigated the current crisis and lowered systemic financial risk.

In Section II we provide background on SAMs and their potential importance in reducing foreclosures and preventing a slump in homeownership. Housing is a very risky investment, and SAMs open up to households the same mix of debt and equity finance long available to businesses.⁴ As we now know, the problem with pure debt finance is that even a small reduction in the homeowner's ability to repay can trigger default and foreclosure. In contrast, when the value of a company such as Google declines by a corresponding amount, the business is neither in breach of contract nor at risk of dissolution. If anything, pure debt finance is even worse suited to housing finance than to business applications, since fluctuations in home values are largely beyond homeowners' control. Of course, capturing the gains from trade that SAM markets promise to liberate is not trivial. We summarize in Section II a better engineered version of the SAM, the SAMANTHA (a SAM with A New Treatment of Housing Appreciation) that increase their market potential. We use the

² See Jones, Oliver, and Leo Grebler, 1961, *The Secondary Mortgage Market: Its Purpose, Performance, and Potential*. UCLA Business School, Los Angeles, CA.

³ On the current crisis, see Pearlstein, S., 2008, "Stimulate the Economy, Don't Play Politics with It." *Washington Post*, January 9, p D01; Summers, Lawrence, 2008, America needs a way to stem foreclosures, *Financial Times*, Economists' Forum, February 25; and Herszenhorn, David, and Vikas, 2008, "Congressional Memo: Tricky Task of Offering Aid to Homeowners." *New York Times*, April 6, 2008. On housing affordability, see Abramowitz, David M. and Andrew Jakobovics, "Shared Equity in Action: Recovery and Affordability Are Possible Amid the Crash in Housing Prices." April 9, 2008, Center for American Progress, Washington, D.C and Caplin, Andrew, James Carr, Frederick Pollock, and Zhong Yi Tong, 2007, "Shared-equity Mortgages, Housing Affordability, and Home Ownership." Fannie Mae Foundation Special Report, Washington, D.C.

⁴ The deep economic logic underlying development of SAM markets was stressed by Caplin, Andrew, Chan, S., Freeman, C., and Tracy, Joseph. 1997. *Housing Partnerships: A New Approach to a Market at the Crossroads*. MIT Press, Cambridge, Mass.

collective term SAM for all such instruments, providing a general definition that captures essential common elements in Section IV.

Unfortunately, the legal research we outline in Section III indicates that current tax rules make it essentially impossible to develop SAM markets in the U.S. Hence there can be no market test of the ability of such markets to resolve the current crisis and to reduce the scale of the impending fall in the rate of home ownership. We highlight three issues in particular.

- A. **The No-Rulings List.** Ever since issuing an extremely narrow ruling in 1983, Treasury has placed SAMs on the “No Rulings” list. This has made it impossible to get advance rulings on the ownership implications and the tax status of borrowers and lenders using SAMs.
- B. **Uniquely Punitive Treatment.** For any original-issuance SAMs that somehow managed to slip past the “No-Rulings” blockade, what would await is uniquely punitive treatment. Investors would be taxed on imputed interest prior to the borrower paying off the loan, with no corresponding offset for borrower. What makes this treatment unique is that it derives from a rule generally relating to a distinct class of debt instruments that are symmetric as between borrower and lender. Investors would surely shun a novel mortgage security when the only certainty would be the need to pay extra taxes, with no certainty as to how much would ultimately be received or when.
- C. **Incoherence.** In contrast with how poorly SAMs are treated under current law when they are issued as part of an original financing, they are treated quite well if they are issued as part of a workout or refinancing. As is the case with original financing, the borrower remains on the cash method of accounting. The lender, however, is treated quite differently. Although there is some uncertainty, it appears likely that the lender would be able to defer most or all of the contingent interest under the SAM until receipt – perhaps even longer! It is very difficult, if not impossible, to justify such disparate treatments of the same instrument based solely on the circumstances under which it was issued.

Given the disorderly state of the current rules and the potential social value of SAMs, we regard it as important to reconsider their tax status, if only to increase the coherence of the tax system. In Section IV we outline three possible methods of rectifying tax treatment of SAMs and propose one in particular as the most effective. The method we propose is particularly straight forward to implement. We believe that it can be carried out entirely through regulatory as opposed to legislative channels. Moreover it is sensitive to the forces at play when Treasury placed SAMs on the “No Rulings” list. Our proposal calls only for an explicit expansion of the “safe harbor” that the initial ruling provided, and rectification of the uniquely punitive treatment of SAMs through elimination of the imputed interest tax on investors. By carefully limiting the scope of the proposed changes, we aim to ensure that they would have few if any consequences outside this narrow setting, denying new tools to tax payers seeking loopholes through which to reduce tax liabilities.

II. THE RATIONALE FOR SHARED APPRECIATION MORTGAGES

In the aftermath of current mortgage market problems, there is a widely perceived risk that the homeownership rate will significantly decline as credit is withdrawn from younger and less well-off borrowers. One possible role for SAMs is to expand housing affordability and thereby to moderate the fall in ownership rates. Consider a household seeking to purchase a \$200,000 home, while having only \$20,000 for a deposit. In the current debt-based mortgage market, the household must seek a standard (debt) mortgage in amount of \$180,000 to be paid off in monthly installments. In addition to high monthly payments, such high borrowing imposes substantial risks, since any significant fall in the value of the home places the borrower in a negative equity position. The recent period bears witness to the high risks of this home purchase strategy, which is likely to become ever more expensive in the aftermath of the current crisis. It is in this context that interest has been stimulated in SAMs as ideal complements to standard mortgages for home purchases. A simple example illustrates the workings of such a mortgage for the household seeking to purchase a \$200,000 home based on a \$20,000 deposit. *Example 1* illustrates how this would work in practice.

Example 1: Consider a \$40,000 shared-appreciation mortgage for 20 percent of a house valued at \$200,000. There is no interest during the life of the loan, and 40 percent of appreciation is due at the end of the period for which the mortgage is held. The amount due on the shared appreciation mortgage depends what has happened to the value of the home.

A: If the house has increased in value to \$400,000, the borrower pays back \$120,000 at point of termination (the \$40,000 initial loan and \$80,000 of the \$200,000 in appreciation).

B: If the house has stayed constant in value at \$200,000, then the borrower pays back the original \$40,000 at point of termination since there is no appreciation to share.

C: If the house has fallen in value to \$100,000, the borrower again pays back the original \$40,000 at point of termination since there is no appreciation to share.

The advantages of incorporating such a SAM into the financing mix lies in its **superior risk sharing** and **superior timing** properties.

- **Risk Sharing:** With regard to risk sharing, the very fact that the cost of SAM finance is low when the house performs poorly and high when it performs well produces a sharing of risk. As for businesses, the combination of debt and equity spreads risk across the financial system, reducing the chance of borrowers being “under water” when home prices fall. This reduces the risk of default-driven financial crises such as that we are now facing.
- **Timing:** The fact that monthly payments during the life of the loan are replaced by a lump sum at termination enhances affordability for younger households early in the life

cycle of earnings. Moreover, repayment can often (but not always) be timed to coincide with sale of the house, at a time when all equity in the house is released.

CCPT illustrate a problem with the simple SAM, which is the incentive the borrower has to hold onto the mortgages for as long as possible to lower the cost of capital. They also outline a novel variant of this mortgage that is immune to this problem, and in which the amount due at termination corresponds to a share in the value of the home that increases the longer the loan has been outstanding. The rate of growth in this share is called the shared-equity rate. Conceptually, the shared-equity rate is a rate of interest charged in terms of real housing units. With the simple shared equity rate mechanism detailed in CCPT, the dollar amount due upon termination is determined directly by multiplying the share of the loan due by the value of the house. With this mechanism, declining house prices can reduce indebtedness below the original loan value. As noted below, this does not fit well with current tax rulings, hence in what follows we will work with a variant in which the payoff is never allowed to fall below the initial loan value. It is this shared appreciation mortgage based on a new treatment of housing appreciation that is referred to as the SAMANTHA. We illustrate precisely how this mortgage would work in practice in *Example 2*.

Example 2. Consider a \$40,000 SAMANTHA for 20 percent of a house of value \$200,000 with a shared-equity rate of 4 percent p.a. With this mortgage, there is no interest during the life of the loan, and the borrower owes the lender the minimum of \$40,000 and a share of house value that increases at 4 percent p.a. over time: from 20% at initiation; to $20(1.04) = 20.8\%$ after one year; to $20.8(1.04) \approx 21.6\%$ after two years; to 24.33% after 5 years; and to 29.6% after 10 years. To illustrate, suppose that the mortgage is paid off after 5 years, at which point the corresponding share of house value due is 24.33%.

A: If the house has increased in value to \$400,000, the borrower pays back \$97,320 at point of termination, corresponding to 24.33% of the house value.

B: If the house has stayed constant in value at \$200,000, the borrower pays back \$48,660 at point of termination, again corresponding to 24.33% of the house value.

C: If the house has fallen in value to \$100,000, the borrower pays back the originally borrowed \$40,000 at point of termination, since this is larger than 24.33% of the house value.

The advantages of the SAMANTHA over the SAM rest on the simple cost of capital which guards against adverse selection and moral hazard.

Simple cost of capital: To a first approximation, the real cost of a SAMANTHA is always 4% p.a. above the real rate of return on housing, regardless of the rate of inflation and the length of time for which the money is borrowed. In contrast, with a SAM, the cost of capital is lower the longer the mortgage is outstanding. To see this, note that in *Example 1* at point of origination of the SAM, 40% of appreciation is due as interest on only 20% of the house value. Later in the term of the mortgage this same 40% of appreciation is due as interest, but the obligation typically exceeds

20% of the house value due to house price increases in the period following origination. In addition, note that an increase in inflation raises the real cost of the SAM to the borrower, since it gives rise to additional appreciation, which is then shared with the lender (it was this effect that made lenders particularly keen on this form of finance in the late 1970's).

Adverse Selection and Moral Hazard: Given that the cost of capital diminishes with the holding period, the SAM is likely to attract primarily those who wish to hold onto this form of finance for a long time. Moreover, the declining cost of capital provides an incentive for borrowers to hold onto the mortgage for as long as possible.

In addition to outlining new forms of SAMs, CCPT provided a detailed analysis of how their use would enhance housing affordability without raising risk. They detailed how SAMs allow less well off households to obtain homes with low down payments, yet without requiring outside bets on future house prices. For example, with a SAM as opposed to a traditional mortgage, a household with an income of \$20,000 and assets totaling \$10,000 would be able to afford a home that is 24 percent more valuable. CCPT also provided survey evidence of high consumer interest based on a 1500-respondent survey conducted in February 2006. The survey targeted households that felt it was at least "somewhat important" to buy their next home within the next five years. It then illustrated the workings of a version of the SAMANTHA. Among all relevant demographic groups, 15 to 22 percent reported being highly likely to consider using it, while 60 to 67 percent reported being at least somewhat likely to consider its use. They were explicitly preferred to the interest-only and negatively amortizing mortgages that have played such a significant role in the recent housing crisis.

In addition to their long run roles in enhancing affordability in a low risk manner, SAMs are attracting particular attention in the current sub-prime crisis, which can be seen as a predictable if tragic evolution of the debt-only system of housing finance. From the late 1990's until 2006, home prices in much of the country went through a long upswing, the economy was moving ahead smoothly, equity markets were strong. Even academics chimed in, proclaiming that the "Great Moderation" was here, and with it a greatly dampened business cycle. With house prices growing faster than incomes, pressure grew for innovative mortgages to prevent households from being locked out of the opportunity for wealth creation that home ownership appeared to represent. Unfortunately, it is very difficult to design standard mortgages that expand affordability. One can reduce the down payment, but only at the expense of increased mortgage carrying costs (due both to the larger amount borrowed and the increase in risk). How creative it appeared when new mortgage products were made available allowing lower payments early in the amortization period in exchange for higher payments later.

We know how this has turned out. Once the implicit bet on house price increases failed, the problems with sub-prime mortgages became clear to all participants. Many households who relied on increased house prices to bail them out if they were unable to make the payments are now beginning to default, and foreclosures are rapidly increasing. The analogy between business and housing finance that was introduced above suggests how this turn of events has induced interest in sharing of equity. Consider a small business which had been lent money

just before the onset of an industry-wide slump. In light of the slump, the business might find it impossible to pay the installments due on the initial debt. Provided the manufacturer was competent, viable on a day-to-day basis, and well-suited to running the business, every effort would be maintain the business as an ongoing operation. One way to accomplish this would be for those who initially loaned money to allow some of their debt to be converted into equity in the business, which should be expected to return to profitability as the industry recovered. An alternative would be for them to be at least partly taken out by a third party equity investor better suited to the risks involved in issuance of equity. Current proposals involving equity strips are essentially designed to facilitate this form of renegotiation.

A key question relating to long run market potential is the extent to which lenders would be willing to fund SAMs. Current proposals in this regard are based on best practices in the standard mortgage-backed securities market. "SAM-backed securities", comprising individual SAMs packaged together, would be sold to investors interested in residential real estate returns. Such securitizations would create investor properties for the mass market, and avoid the agency problems that underlie the current collapse of confidence in mortgage backed securities. The possibilities for overly generous appraisals and income assessments would be far lower given the SAM investor's directly interest in the borrower's ability to repay and in the value of the underlying collateral. Moreover, unlike sub-prime mortgages, such securitizations would be designed to attract a clientele aware of the risks they are taking. Just as investors in Google accept fluctuations in share values as par for the course, so investors in SAM-backed securities would be accepting of risks related to house prices. Rather than providing tax-funded guarantees to bail out disappointed losers, the federal role could largely be limited to setting rules of market conduct. SAM markets would enable socially oriented lenders to do well while doing good, while guiding less socially oriented participants into doing good while doing well.

III. TAX OBSTACLES:

III.A. THE NO-RULINGS LIST

Ironically, tax barriers to SAMs were first erected precisely as the market was initiated in the 1980's. In that inflationary period, the interest rate on conventional home mortgages was 18% p.a., making installment payments on mortgages prohibitively expensive. It was in that context that the first general purpose SAMs were developed. The basic instruments allowed the interest rate to be cut from 18% p.a. to 12% p.a. provided the borrower was willing to share appreciation with the lender.

SAMs sit in the grey area between debt and equity. Hence in order to make these mortgages available to the public, it became necessary for originators to seek clarity from the IRS regarding the ownership status of the home, as necessary for the borrower and lender to file taxes. It was the response to this question concerning the "federal income tax consequences to a mortgagor under a shared appreciation mortgage loan used to finance the purchase of a personal residence" that forms the first level block on market development. Revenue Ruling

83-51 ruled that regular interest payments during the life of the loan and final payments of contingent interest could be deducted for tax purposes. Critically, the ruling was limited to “the fact situations set forth above”, which included a detailed description of the mortgage in question. At the same time, all other forms of SAM were explicitly moved to the “No Rulings List”, where they remain to this day. In Revenue Procedure 83-31, very shortly after issuing Revenue Ruling 83-51, Treasury added SAMs to the list of issues on which it will not issue advance letter rulings or determination letters.

“Section 163.—Interest.—The income tax consequences of transactions involving “shared appreciation mortgage” (SAM) loans in which a taxpayer, borrowing money to purchase real property, pays a fixed rate of interest on the mortgage loan below the prevailing market rate and will also pay the lender a percentage of the appreciation in value of the real property upon termination of the mortgage. This applies to all SAM arrangements where the loan proceeds are used for commercial or business activities, or where used to finance a personal residence, if the facts are not similar to those described in Rev. Rul. 83-51, 1983-1 C.B. 48. (Also §§ 61, 451, 461, 856, 1001, and 7701.)”

This has remained its position for the last 25 years, as evidenced by Revenue Procedure 2008-3. The implication, then, is that anyone who is issuing anything other than a precise copy of the original SAM is unable to make definitive representations concerning tax treatment and ownership. To understand the damage this does the market, one need only consider the aborted effort of Bear Stearns to re-introduce SAMs into the U.S. in the 1990’s. Given that tax uncertainties could not be resolved via a ruling, the brochures introducing these novel mortgages to borrowers included the following stark warning: “The application of the federal income tax rules to a SAM is both uncertain and complicated, and the rules will affect each borrower differently. Accordingly, you must talk to your tax advisor about the federal income tax consequences to you of borrowing under a SAM”.⁵ No wonder the product was swiftly withdrawn!

IIIB. UNIQUELY PUNITIVE TREATMENT

As a general proposition in a well-designed tax system, borrowing transactions should not affect the size of the tax base, i.e., the interest that the lender must include should be precisely offset by the borrower’s deduction. As long as the lender and the borrower are in the same tax bracket and use the same method of accounting, there should be no net tax cost (or tax benefit) associated with these transactions. Unfortunately, there is a huge tax cost associated with SAMs, and this tax cost makes them extremely unattractive for most taxpayers.

Under current law, debt instruments that have original issue discount (OID) are generally treated under the accrual method of accounting: both the lender and the borrower must take into account OID as it accrues, even though one (or both) of the parties might

⁵ See Caplin, Andrew, 2000, “Inertia in the U.S Housing Finance Market: Cases and Causes.” New York University, paper prepared for joint AEA/AREUEA session, New Orleans.

otherwise be on the cash method. The accrual method of accounting is thought to be the most accurate and its use minimizes the opportunity for taxpayers to design transactions that take advantage of uneconomic rules.

There are, however, exceptions to this rule. Under certain circumstances where the chances of abuse are limited, there are situations where these accrual rules are relaxed. For example, under § 1274A, a borrower and a lender can jointly elect to use the cash method of accounting to report the OID on certain relatively small debt instruments received in exchange for property. This provision is relatively narrow: the stated principal amount of the debt instrument cannot exceed \$2,000,000, the lender must not be an accrual method taxpayer, and the lender cannot be a dealer with respect to the property sold. Note that under this exception, since both the borrower and the lender will report the interest using the same method of accounting, if they are in the same tax bracket, there will be no net tax cost (or benefit) associated with this transaction.

Originally, debt instruments bearing contingent interest, such as SAMs, were not subject to these OID accrual rules. Contingent interest was thought to be too speculative to accrue during the term of the instrument and was taken into account by accrual method taxpayers at termination, when the amount of the interest became fixed, and by cash method taxpayers when it was paid or received. At that time, SAMs were treated almost symmetrically: Except in the case where the lender refinanced the SAM, both the borrower and the lender would account for the interest at termination. For this reason there was very little, if any, net tax cost associated with these instruments.

In 1996, the tax treatment of SAMs changed dramatically when Treasury finalized the regulations under § 1.1275-4. These regulations generally subject debt instruments bearing contingent interest to the OID provisions, requiring both the borrower and the lender to accrue the contingent interest as though the instrument bore a market rate of interest. These rules are tax neutral for most instruments, since both the borrower and the lender account for the contingent interest using the same method of accounting. They are not neutral, however, in the case of SAMs. The reason for this is that only the lender under a SAM is subject to these rules, the borrower is not. Under § 1275(b)(2), the borrower cannot deduct the contingent interest until she pays it. As a result of the interaction of the contingent interest regulation and this provision, the lender and the borrower are forced onto different methods of accounting, creating a huge net tax cost that makes SAMs extremely unattractive.

To illustrate how SAMs are currently treated, consider the facts of *Example 3*. Note that the examples used in the tax section are designed for numerical simplicity, and hence involve different dollar amounts than the examples of the last section, which were designed to illustrate issues relating to affordability.

Example 3: Borrower (“B”) purchases a residence for \$500,000 financed as follows: \$100,000 down payment, \$300,000 conventional 30-year mortgage, and a SAM for \$100,000. Under the SAM, no interest is payable until termination, which will occur at the earliest of (1) prepayment of the mortgage, (2) transfer of ownership of the residence, or (3) 10 years from the date of the mortgage. At termination, B

must pay the Lender (“L”) the \$100,000 “principal” on the SAM plus an amount equal to 40% of any appreciation in the residence. In each of the following alternatives, assume that 10 years have passed and the home is worth \$700,000.

Assume throughout that the market rate of interest for 30-year conventional mortgages is 6% and that B and L are both in the 35% bracket.

Current Law: The Contingent Interest Regulations. If the SAM is a debt instrument and the amount payable thereon is contingent interest, then under current law, L would be required to accrue interest income during the term of the SAM at the market rate of interest of 6% annually on \$100,000, and B would be entitled to a deduction for the contingent interest only when she actually pays it.

Tax Consequences to the Lender: Over the 10-term of the SAM, L will be required to accrue \$79,085 of interest income. At a 35% tax rate, the present value of L’s tax liability on the date that the instrument is issued is \$22,153. In addition, at termination, L must include an amount equal to the actual interest due under the SAM (\$80,000) over the amount previously accrued (\$79,085), or \$915. The tax due on \$915 is \$320, the present value of which is \$218. Therefore, the present value of the L’s tax liability from this transaction is \$22,371.

Tax Consequences to the Borrower: The tax consequences to B depend, in part, on the event that triggers the termination and on the source of the funds that B uses to satisfy her obligation under the SAM.

Sale. If the termination is triggered by a sale of the home for \$700,000, then B has a gain of \$200,000, all of which is excludible under § 121. At the time of the sale, B must pay \$180,000 to L, \$80,000 of which is contingent interest. This interest is deductible, resulting in a tax savings to B of \$28,000. The present value of this tax savings as of the date the SAM was issued is \$19,099. Note that in present value terms, L’s tax liability from this transaction is \$3,272 more than B’s tax savings (i.e., \$22,371 less \$19,099). This is the net tax cost of this transaction.

Refinancing. If B refinances the SAM with a new mortgage secured by the home for \$180,000, then the tax consequences to B depend on whether the refinancing is with a third party lender, or with L. If with a third party lender, B will be treated as though she paid L the \$80,000 of contingent interest, and will be entitled to a deduction. If B refinances the SAM with L, however, the tax consequences are significantly different. Since L is providing the funds to pay the contingent interest, the refinancing is not considered payment and therefore the contingent interest is not currently deductible by B. Instead, B will be entitled to deduct the contingent interest on the SAM only as she pays the principal of the new mortgage. Four-ninths of all principal payments (i.e., 80/180) will be considered interest due under the SAM. Obviously this reduces the present value of the tax savings for B further.

IIIC. INCOHERENCE

As we have demonstrated above, SAMs are treated very poorly when issued as part of an original financing. There is no evidence that this treatment was intentional. The drafters simply did not have SAMs on their screens. In this section we examine the tax consequences to both the borrower and lender if a SAM is issued as part of a workout or refinancing. Interestingly, once again, it appears that the drafters of the relevant rules did not have SAMs in mind. The rules are poorly designed and plagued with uncertainty. But this time, however, it is likely (although not certain) that SAMs are treated *better* for tax purposes than conventional financing. In our view, the two disparate ways that SAMs are treated depending on the circumstances of their issuance is incoherent and is further evidence that their tax treatment should be rethought.

In this section we will first look generally at how the borrower and the lender are treated as a result of a refinancing in which a SAM is issued. We briefly describe § 1.1275-4(c), which is the regulation that controls the tax treatment of both parties. This provision in particular is poorly designed for SAMs and creates needless uncertainty. We then examine the tax treatment of the borrower. As a result of the refinancing/workout, the borrower might have some cancellation of indebtedness income. The borrower's tax treatment with respect to the SAM is uncertain, but we believe that her tax treatment will probably be very similar to that described above for an originally issued SAM. Finally we examine the tax treatment of the lender. Although the tax treatment to the lender is also uncertain, it is surely much better than when the SAM is originally issued: in all probability, the lender will have to report little if any of the contingent interest on the SAM before receipt of that interest, and may be able to defer reporting a portion of that interest even longer!

In order to facilitate our examination of these issues, we will use the following variation of our previous example.

Example 4: Several years ago, B took out a conventional 30-year mortgage. This year, when the balance (and the adjusted issue price) on the mortgage is \$400,000, B refinances that mortgage with a new conventional 30-year mortgage in the amount of \$300,000 bearing 6% interest and a SAM for \$100,000 with the same terms as in **Example 3**. Assume again that 10 years have past and the home is worth \$700,000. Assume throughout that the “applicable federal rate” (“AFR”) is 4.5%.

In General: The transaction described in the **Example 4** is a debt-for-debt exchange between the borrower and the lender. In a debt-for-debt exchange, if there is a “significant

modification”⁶ of the debt instrument, then the exchange is a taxable event for both parties. On the facts of the *Example 4*, we are confident that there has been a significant modification and that both parties are taxable. The issue price of the “new” debt instrument is generally determined under § 1274.⁷ Under this provision, the issue price would be the lesser of (i) the noncontingent principal, and (ii) the present value of all noncontingent payments (discounted back at the AFR).⁸ The contingent interest component is ignored, at least initially. On the facts of the *Example 4* the issue price for the new instrument is \$400,000.⁹

When a SAM is issued as part of a refinancing, the parties are no longer governed by § 1.1275-4(b), but rather under § 1275-4(c). This regulation was designed for the sale and purchase of property where a portion of the sales price was contingent. Although it works fairly well in most cases, in the context of SAMs it operates in a bizarre fashion. Under this regulation, we are told to treat all noncontingent payments, both principal and interest, as a single instrument and to take into account contingent payments only if and when they are

⁶ Under Reg. § 1.1001-3, a debtor is treated as issuing a new debt in satisfaction of an old debt if there is a “significant modification” to the old debt. Converting a conventional mortgage into a SAM generally should be treated as a “significant modification” for these purposes. Under Reg. § 1.1001-3(e)(1), a modification is significant “if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.” The § 1.1001-3(e) regulations then go on to provide some specific categories such as significant changes in the yield to maturity or the payment dates. Application of such specific categories to the SAM modification might be less than certain as the contingencies prevent an upfront determination of, e.g., the actual yield to maturity. Nonetheless, it seems reasonable to conclude that the SAM modification would be caught either by the specific yield to maturity category, or the more general “economically significant” standard. See Paul H. Asofsky, 56 NYU Institute, Sec. 5.07 (change from a fixed rate to a contingent instrument is a significant modification due to the change in the yield to maturity).

⁷ This assumes that the debt instruments are not publicly-traded. § 1274 generally applies where new debt is issued in exchange for property if neither the new debt nor the exchanged property is publicly traded. There is an exception from § 1274 for debt instruments arising from the sale or exchange of a principal residence, but the new debt here arises from an exchange of the mortgage, not the sale of the home itself. IRC §1274(c)(3)(B). There is another exception from § 1274 if the total payments to the lender under the workout (including all amounts payable under the new debt) do not exceed \$250,000. See § 1274(c)(3)(C). If so, then the issue price would equal the “stated redemption at maturity,” which generally includes all payments other than “qualified stated interest.” § 1273(b)(4); § 1.1273-1(b). For COD purposes, § 108(e)(10)(B) further refines the issue price to exclude all interest. As such, the likelihood of COD would be reduced if the § 1274(c)(3)(C) exception applied since the issue price would then include all “principal” at the full face amount. But there is some uncertainty as to the application of the \$250,000 exception in the SAM context since the \$250,000 threshold includes all payments under the debt instrument, and not just the fixed amounts. Even if the stated principal on the workout loan was less than \$250,000, the uncapped SAM provides for potential aggregate payments in excess of \$250,000. Cf § 1.483-4(b)(ex.1)(contract provided for \$200,000 principal plus contingent interest capped at \$50,000).

⁸ Reg. § 1.1274-2(g).

⁹ This is determined by taking the lesser of (i) \$400,000 (the noncontingent principal) or (ii) \$419,376 (the sum of the present value of all payments under the \$300,000 conventional loan, plus the present value of the \$100,000 principal of the SAM due in 10 years using a discount rate of 4.5%).

paid. At that time, the contingent payments are discounted back to the issue date by the AFR and a significant portion of the payment is characterized as “principal.” This has the effect of converting a significant portion of the contingent interest on the SAM into something else. On the facts of the *Example 4* when the \$80,000 contingent interest is paid 10 years after the issue date, only \$28,416 is characterized as interest, the balance of \$51,584 (\$80,000 discounted back ten years at 4.5% p.a.) is treated as additional principal. It is not entirely clear how either the Borrower or the Lender should treat this amount which we will refer to as “additional principal.”

Tax Consequences to the Borrower: As a result of the workout/refinancing B may have cancellation of indebtedness income (“COD”).¹⁰ This occurs whenever the issue price of the new instrument is less than the adjusted issue price of the old one. On the facts of the *Example 4*, since both issue prices are the same, there is no COD. If, however, the AFR were higher, say 5%, then B would have COD income. Fortunately for the taxpayer, the Mortgage Forgiveness Debt Relief Act of 2007 generally would allow the Borrower to avoid reporting any such COD income, but only for tax years 2008 and 2009.¹¹ Instead, the Borrower would have to reduce the basis in the home by the unreported COD income.¹² Assuming the homeowner can exclude the COD, she generally would receive a net tax benefit in the form of an offsetting amount of deductible interest upon payment.¹³ Starting in 2010, however, the homeowner would have to report the COD absent a legislative extension of the COD exemption, or unless the owner separately qualified for the insolvency or bankruptcy exception.¹⁴

¹⁰ Under Reg. § 1.61-12(c)(2)(ii), COD income is the excess over the adjusted issue price over the repurchase price. To determine the repurchase price where the old debt is satisfied by new debt, these regulations cross reference § 108(e)(10). Section 108(e)(10)(A) provides that for COD purposes, the debtor is treated as having satisfied the old debt with an amount of money equal to the new debt’s issue price.

¹¹ § 108(a)(1)(E), (h). The COD exemption does “not apply if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.” IRC § 108(h)(3).

¹² § 108(h)(1). This is a very pro-taxpayer rule: In exchange for the reduction in basis, the Borrower will be able to deduct a similar amount of interest when payment is made. See discussion in note 13 and accompanying text *infra*.

¹³Technically, the loan’s issue price would be less than its stated redemption price at maturity (even without regard to the contingent payments), thereby creating OID on the non-contingent portion of the instrument. While the lender would have to include that OID over time, the Borrower could deduct it only upon payment under the IRC § 1275(b) rules described above more generally for the SAM contingent interest (i.e., when issued originally for cash under the 1.1275-4(b) regulations). Thus, as to any COD amount, the owner trades basis in the home for an interest expense. The interest expense generally is more favorable as gain on sale either is exempt or taxed at favorable rates. This would not be the case, however, for a wealthy homeowner who cannot deduct all the mortgage interest expense due to the dollar limitations under IRC § 163(h)(3)(B).

¹⁴ See § 108(a)(1)(E) for the expiration of the homeowner exception after 2009. See § 108(a)(1)(A) (“Title 11” exception), 108(a)(1)(B) (“insolvent” exception).

The tax consequences to B of the newly issued SAM are fairly straight-forward except for the additional principal. B is entitled to a deduction for the 6% annual interest paid each year on the conventional mortgage and, in addition, she is entitled to a deduction for \$28,486 for that portion of the contingent payment characterized as interest when it is paid. It is not clear, however, how to treat the additional principal. It is not at all clear how to characterize this additional principal and, therefore how to treat it for tax purposes is unclear. There are at least three plausible ways to treat it. First, it could be added to the basis that B has in her residence. We believe this is a stretch because B did not acquire the residence in the debt-for-debt exchange; she acquired new debt. Second, it could be treated as a “retirement premium” on the old debt.¹⁵ We believe this is the most appropriate way to characterize the

¹⁵ Under Reg. § 1.163-7(c), repurchase premium in a debt for debt exchange is treated like OID (and therefore deductible only when paid in the case of a home mortgage). Technically, the repurchase premium is the excess, if any, of the issue price of the new debt over the adjusted issue price of the old debt. As discussed above, the new debt’s issue price – at least initially – is based solely on the noncontingent payments. In some sense, this is inconsistent with Reg. § 1.1275-4(c) which bifurcates the actual contingent payment into part interest and part principal. A more consistent approach would treat the additional principal on the contingent payment as additional issue price on the debt (issue price conceptually can be viewed as the principal amount for tax purposes). Taking a step back, the homeowner in a meaningful sense has retired the old debt at a premium under the Reg. § 1.1275-4(c) bifurcation approach (and alternatively, without the Reg. § 1.1275-4(c) bifurcation, the full contingent amount would just be deductible interest without regard to the repurchase premium analysis). The potential technical problem, though, is that the 1.163-7(c) regulations refer to the issue price of the new debt, and again, the § 1.1274-2(g) regulations exclude the contingent amount from the issue price calculation. The § 1.1275-4(c) regulations unfortunately do not close the loop by explicitly stating that the issue price should be increased by the principal portion of the contingent payment. This failure is perhaps explained by the § 1.1275-4(c) regulations’ focus on the treatment of a buyer who purchases new property for a contingent debt instrument. In this regard, note that the 1.1275-4(c) regulations provide in that context that the buyer gets additional basis in the purchased property for the principal portion of the contingent payment. If our context, if the owner were denied an interest deduction for the principal portion of the contingent payment she presumably should then increase her basis in the home. But unlike the regulations example, the owner here is not paying additional contingent amounts to the seller of the home, but rather to the 3rd party lender. In this regard, contrast § 108(e)(5), which treats reductions in principal as a purchase price reduction (rather than COD), but only where the debt was issued by the seller of the property. Our situation is the mirror image of the COD/purchase price reduction scenario. Application of these general § 108 rules to our flip side situation therefore arguably supports limiting treatment of the subsequent additional principal as a basis adjustment only to cases where the lender is also the seller. One point in our home mortgage context, though, perhaps cuts in the other direction. As discussed above, if the initial issue price calculation creates COD, such debt “relief” is not includible income, but rather reduces basis in the home even if the lender was not the seller (at least for the next two years). Having said that, though, the rules do allow an OID deduction to the homeowner as an offset to the excludable COD apart from any contingent payments. See note 13 and accompanying text. For a learned practitioner’s attempt to make some sense of these rules outside the home mortgage context, see Paul H. Asofsky, 56 NYU Institute, Sec. 5.08, (taxpayer should be entitled to an ordinary deduction for the principal amount of the contingent payment, at least if the taxpayer had to include the COD income upfront. If the taxpayer did not have to include the COD income due to the insolvency or bankruptcy exception, and instead had to reduce tax attributes, then the treatment of the subsequent payment is unclear, but some adjustment resulting in a tax benefit is certainly required). Note that Asofsky’s analysis seemingly would not cover situations where there is no COD at all (ie, where the new debt’s initial issue price at least equals the old debt’s adjusted issue price) or where the principal on the contingent payment exceeds the amount of the initial COD. Also, apart from any contingent payments, recall again how the rules do allow the homeowner deductible OID as an offset to excludable COD for the noncontingent component.

Note that the technical analysis changes, perhaps in the taxpayers favor, if the total payments to the lender under the workout (including all amounts payable under the new debt) do not exceed \$250,000. See

additional principal. If it is characterized as retirement premium, a further uncertainty is whether it should be fully deductible when paid, or whether a portion instead must be amortized over the remaining life of the new 30 year mortgage. On our facts, it seems that B should be entitled to deduct virtually the entire premium when paid, thereby providing B with essentially the same treatment as under § 1.1275-4(b).¹⁶

Tax Consequences to the Lender: The tax consequences to the Lender are remarkably different from the treatment of the Lender that we described above. It is likely that the Lender will be able to defer some, perhaps all, of the contingent payment until receipt (and possibly beyond) unless the lender is a dealer.¹⁷ However, the exact treatment is uncertain.

Before we explore the uncertainty associated with this transaction, a few results are clear. On the facts of the ***Example 4***, the Lender will have to report the 6% interest each year under her normal method of accounting. In addition, when the SAM terminates, the Lender must report as interest the amount of the contingent payment characterized as interest under

IRC § 1274(c)(3)(C). If so, as noted above, the issue price would then equal the “stated redemption at maturity,” which generally includes all payments other than “qualified stated interest.” Similar to the COD analysis above, the § 1.163-7(c) regulations further refine the issue price definition to exclude all interest. It thus seems that the issue price should then include the present value of all payments, including any ultimate contingent payments. As such, the taxpayer seems to have a stronger case for deducting the premium if the § 1274(c)(3)(C) exception applied. But it is not entirely clear that this reading holds up since the issue price needs to be determined upfront before any contingent payments are made (eg, to see if there is any COD). Furthermore, it is not clear when, if at all, the homeowner on the SAM loan can use the § 1274(c)(3)(C) exception since the \$250,000 threshold includes all payments under the debt instrument, and the uncapped SAM provides for potential aggregate payments in excess of \$250,000.

As a final point, note that the Reg. § 1.1275-4(c) approach is also somewhat inconsistent with the COD analysis above. The COD calculations treat the old debt as being exchanged for new debt with principal based only on the noncontingent amounts. In contrast, the § 1.1275-4(c) regulations retroactively treat the contingent instrument as having a principal amount based on the present value of all payments, including the contingent payments. As such, you could have a seemingly anomalous situation in which the taxpayer has COD income under § 108, yet ultimately is treated as having exchanged the old debt for new debt with a higher principal amount. In the overall sense, the numbers work out assuming the proper basis adjustments and possible OID deductions. Nonetheless, careful coordination of the timing (and character) results seems to be lacking.

¹⁶ Reg. § 1.163-7(c) provides a general rule that the retirement premium in an § 1274 debt-for-debt exchange must be amortized over the full loan term like OID. As discussed above, § 1275(b)(2) blocks any deduction of OID until paid in our homeowner context. Thus, our homeowner presumably can deduct any retirement premium only upon the later of payment or the OID-like accrual over the full 30-year term of the entire debt instrument. On our facts, though, it seems that the owner should be able to deduct virtually the entire premium when paid. This results since the contingent return on the SAM (6.05% p.a.) is only slightly higher than the 6% rate on the conventional \$300,000 loan. Thus, the overall yield to maturity on the debt instrument is only slightly higher than 6%, and so virtually all of the \$80,000 contingent payment would have accrued at the time of the year 10 payment. If the contingent return on the SAM exceeded the interest rate on the conventional portion by a more significant margin, then a more significant amount of the premium presumably would have to be amortized over the full 30-year term.

¹⁷ This also assumes that the debt is not publicly traded. See discussion *supra* at footnote 7. This also assumes that anti-abuse rule of 1.1275-2(g) does not apply. See discussion *infra* at footnote 22.

§ 1.1275-4(c), here, \$28,486. The remaining issue is how and when the Lender should report the additional principal in the amount of \$51,514. Under these regulations, this additional principal is no longer characterized as interest on the SAM, but rather as additional sales proceeds on the debt-for-debt exchange.

As discussed earlier, from the Lender's perspective, the workout/refinancing is treated as a taxable exchange and the Lender's gain or loss is equal to the difference between her amount realized (i.e., the sum of the new issue price plus the fair market value of contingent payment)¹⁸ and the adjusted issue price of the old instrument. It is interesting to note that the Lender might have a taxable gain on this exchange even in cases where the Lender has an economic loss. Initially, this is a result of the way the new issue price is calculated.¹⁹ If the Lender has a loss on the exchange, it may be taken immediately. If there is a gain, then, unless the Lender is a dealer, or if the debt is publicly traded, the Lender is entitled to report that gain using the installment method under § 453.²⁰ In general, the Lender's selling price

¹⁸ Reg. § 1.1001-1(g)(2).

¹⁹ As per above, the issue price of the noncontingent amounts equals the lesser of (i) the stated noncontingent principal or (ii) the present value of all noncontingent payments, discounted back at the low AFR. Where fixed interest is paid at a rate above the AFR on some of the principal, the principal underlying the SAM can increase the inclusion for the noncontingent amounts dollar for dollar under this formula. See the determination of the modified debt instrument's \$400,000 issue price at note 9 supra; without the \$100,000 principal underlying the SAM, the issue price would have been only \$300,000. And as discussed in the text below, the Seller's amount realized then includes both such heightened issue price *plus* a separately determined amount of principal on the contingent payment itself.

²⁰ Absent § 453, the Lender must report gain or loss at the time of the exchange based on an amount realized equal to the sum of (i) the fair market value of any contingent payments at such time, plus (ii) the issue price formula amount for the noncontingent amounts described above. Reg. § 1.1001-1(g)(2). (As an aside, note that there is an inconsistency between the 1.1275-4(c) regulations and the more general 1.1001-1(g) regulations. Under the § 1.1275-4(c) regulations, the principal portion of the contingent amount is the actual payment amount, discounted back at the AFR to the exchange date. It seems, though, that the 1.1001-1(g) regulations trump the § 1.1275-4(c) regulations regarding the lender's exchange gain or loss since (i) the § 1.1001-1(g) regulations are more specific as to this issue, and (ii) the treasury explanation of the § 1.1275-4(c) regulations evidences an intent to defer the buyer's basis increase on the purchase of property outside of the debt for debt exchange context (along with an attempt to limit the buyer's interest deductions). In this regard, note how the seller could not report gain at the exchange time under the § 1.1275-4(c) approach since the discounted back principal portion cannot be known until the contingent payment is made. Such deferred reporting would be inconsistent with the reporting of gain assuming IRC § 453 does not apply. See e.g., Reg. § 15a-453-1(d).) The Lender presumably also must account for the difference between (i) the principal portion of the contingent payment under the § 1.1275-4(c) present value bifurcation, and (ii) the value of the contingent payment previously reported at the time of the exchange. The rules are silent as to the timing and character of such reporting. (Note again that such additional accounting is required due to the above inconsistency between the § 1.1001-1(g) and § 1.1275-4(c) regulations regarding the "principal" portion of the contingent payment. Unfortunately, neither section addresses the proper reconciliation of this difference.) One sensible approach might be to have the Lender report additional gain equal to any such excess of the 1.1275-4(c) principal portion over the exchange value, reportable only for the year of payment. Similarly, the Lender would report loss if the reported exchange value exceeded the 1.1275-4(c) principal amount. As to timing, reporting such difference only in the year of payment seems sensible to avoid a potential statute of limitation issue (generally 3 years, increased to 6 years for substantial understatement, open forever for fraud. § 6501(a),(c),(e)).

under § 453 is the sum of issue price of the noncontingent payments plus the additional principal that will be paid when the SAM terminates. Any gain on the sale is reported over time as the Lender receives principal payments (including both the noncontingent principal payments and the additional principal). Applying these rules to the *Example 4*, the Lender's selling price is equal to the issue price of the noncontingent payments, \$400,000, plus the additional principal, an amount unknown at the time of the refinancing. Since the Lender's adjusted basis in the old debt is also \$400,000, the Lender's gain on the exchange will precisely equal to the additional principal. The only question is when that gain should be reported.

It is not at all clear when Lender should report that gain under § 453 – the provision was not designed for transactions like this.²¹ There seem to be two possibilities. First, it could be reported at termination when the amount of the additional principal is known (\$51,514) and it is actually paid to the Lender. If viewed as interest, this would seem sensible: it would essentially put the Lender on the cash method of accounting with respect to the SAM. But, under these regulations, the additional principal is not viewed as interest, but rather as gain from the sale of the old debt instrument. Typically, the gain on an installment sale is spread out over the entire period for which payments are being received. On our facts, that would mean that the Lender would be entitled to report most, or all, of the \$51,514 gain not on receipt but over the remaining 20 years of conventional mortgage!²² We do not believe this to be very sensible.

A dealer/lender would seem to get the same bad result even if the loan is outside § 1274 where the total payments are below \$250,000. See Reg. § 1.1001-1(g)(2)(ii) (if a debt instrument is covered by Reg. § 1.483-4 (rather than Reg. § 1.1274-2(g)), the amount realized equals the sum of the stated principal amount, reduced by unstated interest, plus the fair market value of the contingent payment). As discussed supra at note 7, however, it is not clear when, if at all, an uncapped SAM would fall outside of § 1274.

²¹ If § 453 does not apply, then the lender seemingly must report such gain at the time of the exchange itself, initially based on the fair market value of the contingent payment at such time. See note 20 supra. For instance, with a contingent value of \$40,000, the Lender would have to report \$40,000 of gain at the time of the exchange. In addition, at the time of the year 10 contingent payment, the Lender would seem to have additional exchange gain of \$11,514: i.e., the excess of the \$51,514 principal portion of the contingent payment over the \$40,000 value originally reported. As noted above, it might seem appropriate to report this gain only for tax year 10, the year in which the amount can be determined. Such approach might seem particularly sensible in our factual setting since the exchange year already has been closed under the statute of limitations. Unfortunately, the regulations do not specify the correct time for reporting this gain, nor whether the character is additional gain (rather than additional interest).

²² Since there is no cap on the amount payable under the SAM, the fixed period rules of Reg. § 15a.453-1(c)(3) would apply. Under these regulations, where contingent amounts are paid out over time pursuant to a regular formula, the taxpayer generally recovers basis pro rata over the time period. If applied to our facts, the lender would recover \$13,333 of basis for each year of the 30-year loan (\$400,000/30). Since the noncontingent principal payments for each of the first ten years are all significantly below that amount, the lender not only would avoid reporting any gain on those payments, the lender seemingly could avoid reporting any gain on the year 10 contingent principal as well since it seems that the unused excess basis for each year generally carries over to the next succeeding year. See Reg. § 15a.453-1(c)(3)(ii)(ex. 2). As such the lender would have about \$68,000 of carryovers from the year 1-10 noncontingent payments (\$133,330 aggregate basis allowances less the aggregate \$65,256 of principal repayments). The general pro rata rule might not apply on our facts, though, since the lender will receive a single disproportionate contingent payment on the earliest of several events, and

In sum, the workout scenario should further the impetus for change. First, refinanced SAMs face uncertainty and complexity roadblocks, much like original issuance SAMs in this regard. Moving beyond these similar impediments, the refinancing analysis has highlighted an inconsistency in the treatment of the refinanced and original issuance SAM. It is difficult, if not impossible, to rationalize such disparate treatment.²³ In addition, having provided such more favorable treatment, the government must now police the distinction between a refinanced SAM and an original issuance SAM.²⁴

the regulations provide a general statement that “if the terms of the agreement incorporate an arithmetic component that is not identical for all taxable years, basis shall be allocated among the taxable years to accord with that component unless, taking into account all of the payment terms of the agreement, it is inappropriate to presume that payments under the contract are likely to accord with the variable component.” It thus seems that the Lender must disproportionately allocate some extra basis to the year of the contingent payment, thereby reducing the basis allocation to the other years. The regulations do not specify the exact adjustment here, but based on other parts of the § 453 regulations, an allocation based on the expected value of the contingent payment seems reasonable. Cf. the examples under the Reg. § 15a.453-1(c)(7) “substantial distortion” rules discussed below. For instance, if the contingent payment had an expected value of say \$40,000, the lender’s basis could be allocated on the assumption that there would be an additional principal payment of \$40,000. Such adjustment would not seem to change the above results, though, since even with such adjustment, the lender’s basis allocations towards the noncontingent principal for years 1-10 could still exceed the noncontingent principal payments by more than the contingent principal component in year 10 (not to mention the extra protection provided by the extra basis allocation in year 10). In fact, this adjustment could actually allow additional deferral compared to the pro rata approach by increasing the unused basis carryforward to year 11.

These results might seem to be too good to be true. In this regard, note how the noncontingent principal payments start low and increase over time. As such, the IRS might invoke the Reg. § 15a.453-1(c)(7) “substantial distortion” rules to accelerate the reporting of the gain. Under these rules, the IRS can successfully override the general pro rata rule if it would allow the taxpayer to recover their basis at least “twice as fast” compared to the IRS’s more exact method. Query whether the “twice as fast” rule would be satisfied on our facts. Even if successfully invoked, the lender probably could still defer most of the gain until – and beyond -- the year 10 payment date. A reasonably fair result might require the lender to report a pro rata portion of the gain on each principal payment. Under such an approach, about 11.41% of each payment would be treated as gain. (\$51,514 gain divided by \$451,514 total principal equals .11409.) At the end of 10 years, the lender would have received only \$116,770 of principal payments (\$65,526 of noncontingent principal plus the \$51,514 principal portion of the contingent debt). As such, the lender still would report only \$13,322 of the \$51,514 gain by the end of 10 years. A separate anti-abuse rule involving the 1275-4 regulations needs to be considered as well. Under Reg. § 1.1272-2(g), the IRS can change the results under the OID regulations if a principal purpose in structuring the debt or transaction was the receipt of an unreasonable tax benefit. In particular, Ex. 2 under the § 1.1272-2(g) regulations states that the Commissioner can apply the 1.1275-4(b) regulations, rather than Reg. § 1.1275-4(c), to a modified debt instrument where, among other factors, a principal purpose of the modification was a substantial reduction to the present value of the holder's tax liability through the application of §1.1275-4(c) (rather than §1.1275-4(b)). We assume the lack of such a principal purpose on our example. For an extreme example which presumably would be caught by the § 1.1272-2(g) anti-abuse rule, contrast a situation where a conventional mortgage is issued on day 1, and is then modified into a SAM on day 2 pursuant to an existing plan on day 1.

²³ The authors have been unable to come up with any such coherent rationalization.

²⁴ See, e.g., the anti-abuse rule of Reg. § 1.1272-2(g), discussed supra at note 22.

IV. RECTIFYING TAX TREATMENT OF SAMs

We outline three possible methods of rectifying tax treatment of SAMs.

- A. **REINSTATE PRE-1996 LAW.** Treasury could essentially reinstate pre-1996 law by amending the contingent interest regulations to exempt SAMs from them. In so doing, they would also provide a definition of the SAM that would prevent possible abuse of the exemption, while expanding the “safe harbor” to enable SAMs to be developed that would pass the market test.
- B. **ALLOW THE BORROWER TO ACCRUE.** Congress could repeal § 1275(b)(2). This would have the effect of requiring both the borrower and the lender under a SAM to accrue the contingent interest during the term of instrument.
- C. **RECHARACTERIZATION AS EQUITY.** Treasury could re-characterize SAMs as equity rather than debt instruments.

While all three of these alternatives would eliminate the current poor treatment of SAMs, we strongly believe that the best of the alternatives is the first. It is easy to implement, and can be structured to have no consequences outside this narrow setting.

IV.A. REINSTATE PRE-1996 LAW

Since the rules relating to contingent interest under § 1.1275-4 were promulgated under authority granted to Treasury, Treasury certainly has the power to create an exception from them if it felt the exception were warranted. We believe one is warranted. Prior to the issuance of these regulations, Treasury was concerned that borrowing transactions were being planned using modest contingencies so as to backload interest. This would have produced a net tax benefit whenever the lender was a high bracket and the borrower in a low one. By placing both the borrower and the lender on the accrual method, Treasury hoped to eliminate this unintended benefit while still treating the loan transaction fairly. SAMs, which were rarely issued during the 90’s, were not the target of these regulations.

Although these regulations work quite well for most loan transactions, they have the unintended effect of singling out original-issuance SAMs for extremely poor tax treatment. As demonstrated above, the reason for this is that the lender under a SAM must accrue the interest, while the borrower cannot. Under § 1275(b)(2), the borrower must remain on the cash method and cannot deduct the contingent interest until she actually pays it. It is this asymmetry that creates the problem.

If Treasury had considered the impact of these regulations on original-issuance SAMs, it might very well have created an exception for them. As a practical matter, this is the only type of debt instrument that is treated poorly. All other debt instruments covered by these regulations under which the interest would be deductible are treated fairly – there is no net tax cost associated with the instrument. Since there is no apparent reason that the use of SAMs should be discouraged, perhaps Treasury should exempt them. If it chose to, it could craft a very narrow exception and could easily be justified. In fact, we now propose a precise definition of a SAM were Treasury to exempt it from § 1.1275-4(b)-(c).

We keep two goals in mind in drafting the definition. First, it must be narrow enough to ensure that instruments used for other purposes than residential home purchases are clearly excluded. Second, it must enable superior SAMs to be developed that better mediate gains from trade, such as the SAMANTHA described in Section 2. We propose the following definition.

1. Both the Borrower and the Lender intend no more than debtor/creditor relationship.
2. Borrower is an individual whose principal residence secures the SAM;
3. Borrower and Lender are unrelated (or, in the alternative, the Lender is a financial institution).
4. Borrower is solely responsible for taxes, insurance etc. Borrower can sell, transfer, or improve the residence without the consent of the Lender.
5. All or part of the interest on the SAM is determined by the appreciation or in the value of the underlying residence.
6. In all events, Borrower is responsible for the full amount of the principal of the SAM.

As noted above, the final requirement rules out the simple shared equity rate mechanism detailed in CCPT, in which a decline in house prices can reduce indebtedness below the original loan value. While it would enhance gains from trade to allow for sharing of losses, constraining such sharing would be of little consequence from a market perspective. Moreover, the impact of this restriction is further diminished in cases in which the SAM is issued alongside a standard interest bearing mortgage, in which case the interest on this mortgage would further limit the otherwise restrictive clause on minimum repayments.

If Treasury did exempt SAMs, the only change from the analysis of current law in the case of original issuance would be that the Lender would not include the contingent interest income until termination. At that time, whether or not paid, the Lender would have income equal to 40% of the appreciation in the residence. This would almost entirely eliminate the timing differences between the Borrower and the Lender and thereby have the effect of eliminating the disadvantageous treatment of SAMs.

In the workout context, exemption from the § 1.1275-4 (both (b) and (c)) regulations would have the additional advantage of removing the uncertainty over the homeowner's deductibility of the "additional principal" portion of the contingent payment.²⁵ The regulatory exemption would have no impact on the COD analysis.²⁶

²⁵ With the exemption from the § 1.1275-4(c) bifurcation, the contingent amount would be treated entirely as interest, and therefore generally deductible when paid.

²⁶ Apart from our specific context, the IRS might want to consider revisiting this area and dealing with the phantom COD income.

With respect to the Lender in the refinance context, as exemplified above, the § 1.1275-4 regulations do not necessarily harm, and might even help, the lender if the lender can use § 453. This results since (i) the “interest” portion of the contingent payment is not reported until paid, and (ii) the gain from the addition principal portion of the contingent payment might be deferred until – or even beyond – the payment date. This results since the § 1.1275-4(c) rules effectively convert some of the contingent interest into principal, with possible benefits under § 453. Having said that, there is some uncertainty over the actual reporting time under § 453. As such, a § 1.1275-4 exemption for workout SAMs would remove some uncertainty along with a potential, and seemingly unjustified, deferral beyond the payment date. Finally, if § 453 does not apply,²⁷ recall the potential adverse consequence in that the lender might have to report an inflated amount of gain at the time of the exchange itself. A § 1.1275-4 exemption would not protect a dealer/lender from having to report “phantom” gain on the exchange under § 1.1001-1(g), due to the double counting of the SAM portion of the loan.²⁸ A further regulatory clarification regarding the lender’s amount realized in the workout scenario therefore might be considered if dealers are an integral part of the market. For instance, payments on the debt instrument might be discounted back at a rate in excess of the AFR (perhaps the fixed interest rate on the original conventional loan or the comparable current fixed rate for a conventional mortgage).²⁹

IV.B. ALLOW THE BORROWER TO ACCRUE

The second alternative treatment would be for Congress to repeal § 1275 (b)(2), permitting homeowners to currently deduct interest under SAMs during the term of mortgage in an amount equal to the market rate of interest, here 6%.

This rule would put both the Borrower and the Lender on the same accounting method, and would therefore eliminate the disadvantageous treatment the original-issuance SAM receives under current law. Throughout the term of the SAM, both would have to accrue interest at the rate of 6% per year. At termination, Borrower would have taken (without paying) \$79,085 of interest deductions.

One appealing aspect of this approach is that it treats all borrowers, including homeowners, the same. Nevertheless, we do not find it as appealing as the first alternative for three reasons. First, this approach would require legislation. As a practical matter, this could prove to be problematic. Second, we believe that there is something to be said for the simplicity and the familiarity of the cash method of accounting for most individual taxpayers. Most individuals are quite familiar with the current rules and might find the deductibility of interest that will not be paid for several years as strange. Finally,

²⁷ This would result if the lender is a dealer or if there was public trading of the debt. See note 20 and accompanying text *supra*.

²⁸ See note 19 and accompanying text *supra* explaining such double counting.

²⁹ Alternatively, the lender’s total amount realized could be set at just the FMV of the new loan, although that requires valuation of the whole loan. In this regard, note that the contingent piece currently must be valued under the Reg. § 1.1001-1(g) approach.

there could be adverse tax consequences to the borrower at termination if the home does not appreciate in value. In such a case, a borrower could end up with a serious liquidity problem. To illustrate, on our basic facts, suppose that the home does not appreciate in value and is still worth \$500,000 at termination. Under this alternative, over the ten year period, B will have taken approximately \$79,085 of interest deductions. Since the home did not appreciate in value, and therefore B will not have to pay L any contingent interest, B will have to include this amount in her income. Although this is the “right” tax result, it could create serious liquidity problems for some homeowners.

The § 1275(b)(2) repeal option also does not correspond well to the special homeowner issues in the workout context. As discussed above, the § 1.1275-4(c) regulations bifurcate the contingent payment into principal and interest components. As highlighted above, these regulations create a homeowner concern on the principal component apart from the timing feature of § 1275(b)(2). That is, the § 1.1275-4(c) regulations create a threshold uncertainty as to whether the owner is entitled to a deduction at all for the principal component (separate and apart from the timing of any such deduction). A potential repeal of § 1275(b)(2) by itself would have no impact at all on that threshold determination. In addition, even if it were determined that the contingent principal qualified as deductible retirement premium, it is not clear how the repeal of § 1275(b)(2) would apply to the timing of the deduction. At first blush, the repeal seemingly would allow the owner to deduct the premium as it accrues over time, even where such accrual predates payment.³⁰ Since the premium would not be determined until a later year, however, it is not clear how the owner would deduct the relevant portion of the premium starting in the first year. Perhaps somewhat related, as discussed more fully below, repeal of § 1275(b)(2) would not necessarily provide a better matching between the lender and borrower (assuming again that the principal portion qualified as retirement premium).³¹

Finally, as regards the interest component, the regulations provide a special rule deferring both the inclusion to the lender and the deduction to the borrower until payment. Repeal of § 1275(b)(2) therefore would have no impact on the interest component.³² It similarly should have no impact on the COD issue.

As for the borrower, the § 1275(b)(2) repeal option does not correspond well to the tax concerns of the lender in the workout context. Again, the interest component under the § 1.1275-4(c) regulations does not raise any timing mismatch issues since both sides defer reporting until payment. As such, the potential concerns relate to the principal component

³⁰ For a discussion of the relevant term in the SAM context, see discussion at note 16 and accompanying text.

³¹ As discussed in Section III.C *supra*, the lender might be able to defer reporting the entire principal portion until – and even beyond – the payment date. On the other hand, though, certain lenders might have to report all of such amount upfront on the exchange. Thus, as discussed below in this Section IV.B, § 1275(b)(2) repeal by itself would not provide symmetry between the lender and borrower.

³² There is no need for reform on this component since there is neither (i) a timing mismatch between lender and borrower, nor (ii) any threshold concern as to deductibility (in favorable contrast to the principal component).

of the contingent payment under the § 1.1275-4(c) regulations. As highlighted in this Section II, the lender's side concern arises where the lender cannot use § 453. In such a case, the lender might have to report income from the contingent payment on the exchange itself. Repeal of IRC § 1275(b)(2), though, would not provide matching treatment in such a case, although it might lessen the adverse mismatch to the parties. As discussed above, § 1275(b)(2) repeal might accelerate some of the homeowner's deduction into the early years, but even this possibility is not certain.³³ In addition, where the lender can use § 453, the repeal of § 1275(b)(2) could extend a timing mismatch in the taxpayers' favor. That is, under current law, the lender might be able to report the income from the principal portion after the time of the borrower's corresponding deduction. If the § 1275(b)(2) repeal did accelerate some of the homeowner's deduction into the early years, this could further accentuate such mismatch.

IV.C. RECHARACTERIZATION AS EQUITY

There are many attractive aspects of treating the lender's interest in a SAM as an equity interest. At least in the case of the traditional SAM, the borrower has no economic interest in the lender's share of the appreciation. If we were to focus in on just SAMs, this approach might be the most attractive alternative. There are, however, collateral consequences that must be taken into account, as well as the possible impact this alternative might have on the characterization of other instruments.

If the SAM is considered an equity interest, then both L and B would be considered to have equity interests in the home. B's basis in her interest in the home would be only \$400,000 (not \$500,000), and L's basis in its interest in the home would be \$100,000. The tax consequences of the sale of the home at termination are straight-forward: B would have an amount realized of \$520,000 and a gain of \$120,000, all of which would be excluded from gross income under § 121; and L would have gain on the sale of its interest in the home of \$80,000. The character of L's gain would depend on whether L is a dealer in these types of interest (i.e., "dealer property").

It should be noted that under this characterization, B is not treated as well as under the debt characterization. The reason for this is that if characterized as a debt, B would have \$80,000 more gain on the sale that would be precisely offset by an interest deduction under current law, and the \$80,000 gain would be excluded from gross income under § 121. Therefore, B ends up with a net \$80,000 deduction that she would not be entitled to if the SAM is characterized as equity.

If B takes out a new mortgage for \$180,000 from an independent third party to pay off, or if you will "buy out," L, B would be treated as if she purchased L's interest in the home and would be entitled to increase her cost basis from \$400,000 to \$580,000. Although it is not clear, we believe that the new mortgage, if secured by the home, should be considered

³³ As discussed above, even with repeal of § 1275(b)(2), doubts would remain as to the deductibility at all of the principal portion, and it is not clear how the owner would deduct the relevant portion of the premium starting in the first year.

acquisition indebtedness and the interest thereon should be deductible. L is treated as having sold its interest and has an \$80,000 gain. The character of the gain is uncertain.

Finally, if B “refinances the SAM” by obtaining a conventional 30 year mortgage from L, this will be treated as a purchase of L’s interest in the home. Therefore, the tax consequences to B should be the same as where B refinances with an independent third party. Once again, L is treated as having sold its interest in the home. In this variation, however, if L’s interest in the home is not considered dealer property, then L may be entitled to treat the transaction as a sale and report the \$80,000 over time.

In evaluating this alternative, one should take into account both the collateral consequences of characterizing a SAM as equity and also its possible implications for other transactions. For instance, an equity characterization could generate adverse consequences for foreign investors under the Foreign Investment in Real Property Tax Act (FIRPTA) or for Real Estate Mortgage Investment Conduits (REMICs).³⁴ These two specialized tax code areas evidence a more general bias in favor of less dramatic corrective changes in order to minimize any unintended consequences.

We turn now to the implications of the equity characterization for a refinance/workout, in which the resulting loan is treated as part debt and part equity (with the equity portion consisting of the appreciation share plus the underlying fixed principal). Let’s consider first the COD consequences. The phantom COD issue generally should be eliminated³⁵ since there should be a bifurcated exchange of (i) part of the old debt for new debt with adequate stated interest, and (ii) the remaining old debt for equity taken into account at its full value.³⁶ Consider next the deductibility of the \$80,000 contingent payment. Following the earlier analysis, the owner could not deduct such payment, but instead would reduce its reportable gain by the \$80,000. In addition, there is one potential new adverse consequence to the homeowner in the workout context. Assuming that the house has declined in value, the homeowner could lose some its basis in the home. Assume, for instance, that the home in our base case declined in value to \$400,000 at the time of the workout. Under the equity characterization, the owner presumably would be treated as selling 25% of the home to the lender.³⁷ The homeowner would have a \$25,000 loss on sale, but such loss would not be

³⁴ Under the current debt treatment of SAMs, foreign lenders who receive the contingent SAM payment from the borrower can avoid negative tax consequences under FIRPTA IRC § 897 since the contingent payment is treated as interest. See Reg. § 1.987-1(h)(Ex. 2); Jeffrey Rubinger, Using Shared Appreciation Mortgages to Avoid FIRPTA, Florida Bar Journal (March 1, 2006). This favorable ability to avoid FIRPTA seems to apply more to an original-issuance SAM than a workout SAM, however, since some of the contingent payment on the workout SAM can be treated as gain rather than interest. See discussion at notes 17 through 22 and accompanying text *supra*. For a potential concern for REMIC investors, see e.g. §§ 860D, 860G, predicating favorable REMIC status on the holding of only “qualified mortgages” and “permitted investments.”

³⁵ Note that there was no phantom COD on our facts since we had enough fixed principal and interest.

³⁶ This is not to say there could not be COD depending, e.g., on the value of the SAM equity. Rather, the possible phantom COD under the debt characterization due to the possible failure to fully account for the contingent piece would be eliminated.

³⁷ This assumes that the equity has a \$100,000 value and the fixed loan has a \$300,000 value.

recognized for tax purposes.³⁸ The end result is a permanent loss of basis in the home equal to the amount of the disallowed loss.³⁹ This could result in the homeowner reporting phantom gain on the ultimate sale of the home where the gain on sale exceeds the exclusion amount under § 121.

Similar to the borrower's phantom COD issue, the equity characterization generally should eliminate the lender's phantom gain on the exchange. This results since the debt modification should be viewed as a bifurcated exchange of (i) some old debt for new debt, with a separate (ii) some old debt for new equity exchange. Such bifurcation therefore removes the "double counting" of the contingent payment discussed above.⁴⁰ As highlighted above, this elimination of the phantom gain could be adverse or beneficial to the lender depending on whether IRC § 453 applies. Again though, if IRC § 453 applies, current law's potential deferral of such phantom exchange gain beyond the payment date seems to be an unwarranted benefit to the lender.

While the present analysis does not definitively argue against the re-characterization as equity, we do see this as an unlikely outcome. The underlying concern that Treasury might have concerns the impact that characterizing SAMs as equity might have on other transactions. The distinction between debt and equity has been one of most vexing issues that Treasury has had to deal with since the inception of the income tax. We believe that the principal reason that Treasury has been unwilling to issue rulings on SAMs for the last 25 years has little to do with SAMs themselves, but because of the implications that these rulings might have on other transactions. If Treasury were to decide to change its long-standing position and characterize SAMs as equity, the implications of this decision could be enormous. For this reason, we strongly doubt that Treasury would choose this alternative even if it were demonstrably superior in the relatively narrow context of the SAM market.

V. CONCLUSION

In light of the current mortgage crisis, there is increased interest in innovative shared appreciation mortgage (SAM) markets. Unfortunately, current tax rules make it essentially

³⁸ The homeowner's basis in the sold portion should equal \$125,000 as she has a \$500,000 basis in the home at the exchange time.

³⁹ The homeowner's basis in the retained 75% of the home would be only \$375,000. Contrast the base case example outside the workout context where the homeowner has a \$400,000 basis in the home apart from the SAM piece.

⁴⁰ Recall *Example 4* where the lender's amount realized equaled \$451,514, of which \$151,514 was attributable to the SAM principal plus contingent interest. See note 19 and accompanying text. Under the bifurcated exchange here, \$300,000 of old debt would be deemed exchanged for \$300,000 principal of new debt with 6% interest. The amount realized for this portion would be only the \$300,000 principal (the alternate present value calculation would exceed \$300,000 at an AFR of 4.5%). The remaining \$100,000 of old debt would be deemed swapped for the SAM equity (\$100,000 fixed amount plus the contingent appreciation share). Gain would be recognized on the exchange only if the SAM equity piece had a value in excess of \$100,000.

impossible to develop SAM markets in the U.S. We propose very limited regulatory changes that would liberate SAM markets, while having few if any consequences outside this narrow setting.