Rectifying the Tax Treatment of Shared Appreciation Mortgages

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I. Introduction

If current trends continue, today's default crisis1 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 U.S. households are 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 come to the fore in the context of the current default crisis, as well as in the context of housing affordability.3 In early 2007, one of us provided a ballpark estimate that introduction of these mortgages would raise the homeownership rate by somewhere in the

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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 fluctuations in the value of houses. 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 Part 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. 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 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, 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 also summarize in Part II a better engineered version of the SAM, the SAMANTHA (a SAM with A New Treatment of Housing Appreciation) that increases their market potential. We use the collective term SAM for all such instruments, providing a general definition that captures essential common elements in Part IV.

Part III outlines current tax rules that make it essentially impossible to develop SAM markets in the United States. 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 homeownership. We highlight three issues in particular. Ever since issuing an extremely narrow ruling in 1983, Treasury has placed SAMs on the “no rulings” list, which has made it impossible to get an advance ruling on the ownership implications and the tax status of borrowers and lenders using SAMs. For any original-issuance SAMs that somehow managed to slip past the no rulings blockade, what would await is unusually punitive treatment. Investors would be taxed on imputed interest prior to the borrower paying off the loan, with no

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4 Fannie Mae Report, note 1, at 211.
5 See Andrew Caplin, Sewin Chan, Charles Freeman & Joseph Tracy, Housing Partnerships: A New Approach to a Market at the Crossroads (1997) (stressing the deep economic logic underlying development of SAM markets).
corresponding offset for the borrower. In contrast with how poorly SAMs are treated under current law when they are issued as part of an original financing, they are treated more favorably if they are issued as part of a workout or refinancing. 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 at least until receipt. It is difficult, if not impossible, to justify such disparate treatment 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, it is important to reconsider their tax status, if only to increase the coherence of the tax system. In Part IV we outline three possible methods of rectifying the tax treatment of SAMs and propose one as the most effective and straightforward to implement as it can be carried out entirely through regulatory rather than 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 punitive treatment of original-issuance SAMs by eliminating inclusion of the imputed interest by 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 taxpayers 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 decline significantly as credit is withdrawn from younger and less well-off borrowers. SAMs could be a very useful tool to reduce this risk. By financing a portion of their homes with a SAM, individuals would be able to significantly reduce their current monthly mortgage payments. The use of SAMs also would result in superior risk-sharing and the timing of payments would be far better.

In this Part, we first describe a traditional SAM. As we demonstrate, the traditional SAM has a design flaw: the longer the SAM is outstanding, the lower its cost to the borrower and the lower its return to the lender. We then illustrate how this flaw can be eliminated by using a newly designed instrument that we christen "SAMANTHA."
A traditional SAM is a mortgage on a residence that entitles the lender to a share of any appreciation in the residence in lieu of fixed interest payments. For example, a SAM lender might be willing to lend 20% of the purchase price of a residence in exchange for 40% of the appreciation in the residence at termination.\(^\text{10}\)

To illustrate how a traditional SAM works and why it might be attractive to some taxpayers, consider a borrower B seeking to purchase a $200,000 home with a $20,000 down payment. Assume that the prevailing interest rate for a conventional thirty-year mortgage is 6%. If B were to take out a conventional mortgage, B would have a monthly payment of approximately $1079. On the other hand, if the household financed the purchase with a combination of a $140,000 conventional mortgage and a $40,000 SAM, the B's monthly payment would be only $839. In addition to lowering monthly payments by $240, the SAM also reduces the risk of the home falling significantly in value, placing the taxpayer in a negative equity position. The following example illustrates how a SAM would work.

Example 1: Suppose B finances a portion of the $200,000 purchase price of a home with a $40,000 shared-appreciation mortgage, on which no interest is payable during the term of the loan. The lender L, however, is entitled to 40% of the appreciation in the home when the mortgage terminates. The amount due on the shared appreciation mortgage depends on the value of the home.

If the house increases in value to $400,000, B pays back $120,000 on termination (the $40,000 initial loan and $80,000 of the $200,000 in appreciation). If the house's value at termination equals its original cost of $200,000, then B pays back the original $40,000 on termination since there is no appreciation to share. If the house falls in value to...
The advantages of incorporating such a SAM into the financing mix lie in its superior risk sharing and superior timing properties. The very fact that the cost of SAM finance is low when the house performs poorly and high when it performs well produces risk sharing. 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. As to 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.

As useful as traditional SAMs are, they have an inherent design flaw: Over time the cost of borrowing on a traditional SAM declines, which creates an incentive for the borrower to hold onto the mortgage for as long as possible to lower the cost of capital. Example 1 illustrates this flaw. Assume that the home appreciates in value by 5% a year every year. Under the terms of the SAM, the lender’s share of this appreciation remains invested in the home until the mortgage terminates. This has the effect of increasing both the amount of the lender’s investment in the home as well as the lender’s percentage investment in the home, as shown by the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>Home Value</th>
<th>L’s Investment</th>
<th>L’s Investment as a %</th>
<th>Current Appreciation</th>
<th>L’s $ return</th>
<th>L’s % return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$200,000</td>
<td>$40,000</td>
<td>20.0</td>
<td>$10,000</td>
<td>$4,000</td>
<td>10.0</td>
</tr>
<tr>
<td>2</td>
<td>210,000</td>
<td>44,000</td>
<td>21.0</td>
<td>10,500</td>
<td>4,200</td>
<td>9.6</td>
</tr>
<tr>
<td>3</td>
<td>220,500</td>
<td>48,200</td>
<td>21.9</td>
<td>11,025</td>
<td>4,410</td>
<td>9.2</td>
</tr>
<tr>
<td>4</td>
<td>231,525</td>
<td>52,610</td>
<td>22.7</td>
<td>11,576</td>
<td>4,631</td>
<td>8.8</td>
</tr>
<tr>
<td>5</td>
<td>243,101</td>
<td>57,241</td>
<td>23.6</td>
<td>12,155</td>
<td>4,862</td>
<td>8.5</td>
</tr>
<tr>
<td>20</td>
<td>505,390</td>
<td>162,156</td>
<td>32.1</td>
<td>25,270</td>
<td>10,108</td>
<td>6.2</td>
</tr>
</tbody>
</table>

Focus first on what happens after the SAM has been outstanding for one year. On the date of purchase, L invests $40,000, an amount that

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12 Fannie Mae Report, note 1, at 218-19.
13 The first three columns represent values at the beginning of the year; the last three columns represent the changes during the year.
represents 20% of the home's value in exchange for 40% of the home's appreciation. After the first year, L's investment increases to $44,000, an amount that represents 21% of the value of the home, although L's share of appreciation remains at 40%. And things only get worse: So long as the home increases in value, L's percentage investment in the home increases every year, while L's share of appreciation remains the same. By failing to take into account the lender's increasing investment, the traditional SAM lowers the cost of borrowing and the return to investors each year, which for the lender is not a very attractive feature.

The Fannie Mae Report identified this flaw and designed a variant that is immune to this problem. 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.\(^{14}\)

Conceptually, the shared-equity rate is a rate of interest that is calculated as a function of the home's value. The dollar amount due on termination is determined by multiplying the share of the loan due by the value of the house.\(^{15}\) In effect, the lender's share of the total value of the home increases each year by the shared equity rate. 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.\(^{16}\) Hence in what follows we work with a variant in which the payoff is never allowed to fall below the initial loan value. We call this variation the SAMANTHA.\(^{17}\) The following example illustrates how this mortgage would work.

**Example 2:** Suppose B financed 20% of the purchase of the home with a $40,000 SAMANTHA (instead of a traditional SAM). Under the terms of the SAMATHA, there is no interest payable currently. Instead, at termination, L is due a share of the home's value that increases over time at the rate of 4% per year, but in all events a minimum of $40,000. Since L financed 20% of the purchase price, that is also L's initial share of the value of the home. L's share of the value of the home would grow at the rate of 4% per year (that is, from 20% at initiation to 20\(\times(1.04) = 20.8\%\) after one year; to 20.8\(\times(1.04) = 21.6\%\) after two years; to 24.33% after 5 years; and to 29.6% after 10 years). Under this SAMANTHA, the cost of borrowing to T and the return

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14 Fannie Mae Report, note 1, at 220.
15 Id.
16 See Part III.
17 An analogous example is detailed in Fannie Mae Report, note 1, at 220-21.
to the lender is not related to how long the mortgage is outstanding, but rather to the home’s appreciation.\textsuperscript{18}

To illustrate, suppose that the mortgage is paid off after five years, when the shared equity percentage (that it, \( L \)'s share of the value of the home) is 24.33\%. If the house has increased in value to $400,000, \( B \) pays back $97,320 on termination, corresponding to 24.33\% of the house value. If the house’s value at termination equals its original cost of $200,000, \( B \) pays back $48,660 on termination, again equal 24.33\% of the house value. If the house has fallen in value to $100,000, \( B \) pays back the originally borrowed $40,000 on 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. To a first approximation, the real cost of a SAMANTHA is always 4\% per annum above the real rate of return on housing, regardless of the rate of inflation\textsuperscript{20} 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. In addition, an increase in inflation raises the real cost of the SAM to the borrower, since it gives rise to additional appreciation, which is shared with the lender

\textsuperscript{18} To illustrate, suppose the home in Example 2 increases in value every year by 5\%. As the table below demonstrates, the lender's rate of return would remain constant over time.

<table>
<thead>
<tr>
<th></th>
<th>Value of home</th>
<th>( L )'s shared equity %</th>
<th>( L )'s investment in home</th>
<th>( L )'s dollar return</th>
<th>( L )'s % return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase</td>
<td>$200,000</td>
<td>20.0</td>
<td>$40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>End of Year 1</td>
<td>210,000</td>
<td>20.8</td>
<td>43,680</td>
<td>$3,680</td>
<td>9.2</td>
</tr>
<tr>
<td>End of Year 2</td>
<td>220,500</td>
<td>21.6</td>
<td>47,699</td>
<td>4,019</td>
<td>9.2</td>
</tr>
<tr>
<td>End of Year 3</td>
<td>231,525</td>
<td>22.5</td>
<td>52,087</td>
<td>4,388</td>
<td>9.2</td>
</tr>
<tr>
<td>End of Year 4</td>
<td>243,101</td>
<td>23.4</td>
<td>56,879</td>
<td>4,792</td>
<td>9.2</td>
</tr>
<tr>
<td>End of Year 5</td>
<td>255,256</td>
<td>24.3</td>
<td>62,112</td>
<td>5,233</td>
<td>9.2</td>
</tr>
</tbody>
</table>

\textsuperscript{19} To illustrate, suppose the home in Example 2 remains worth $200,000. In this case, \( L \)'s rate of return would be 4\% per year because \( L \)'s share of the value of the home increases by 4\% each year:

<table>
<thead>
<tr>
<th></th>
<th>Value of home</th>
<th>( L )'s shared equity %</th>
<th>( L )'s investment in home</th>
<th>( L )'s dollar return</th>
<th>( L )'s % return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase</td>
<td>$200,000</td>
<td>20.0</td>
<td>$40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>End of Year 1</td>
<td>200,000</td>
<td>20.8</td>
<td>41,600</td>
<td>$1,600</td>
<td>4</td>
</tr>
<tr>
<td>End of Year 2</td>
<td>200,000</td>
<td>21.6</td>
<td>43,264</td>
<td>1,664</td>
<td>4</td>
</tr>
<tr>
<td>End of Year 3</td>
<td>200,000</td>
<td>22.5</td>
<td>44,995</td>
<td>1,731</td>
<td>4</td>
</tr>
<tr>
<td>End of Year 4</td>
<td>200,000</td>
<td>23.4</td>
<td>46,794</td>
<td>1,800</td>
<td>4</td>
</tr>
<tr>
<td>End of Year 5</td>
<td>200,000</td>
<td>24.3</td>
<td>48,666</td>
<td>1,872</td>
<td>4</td>
</tr>
</tbody>
</table>

Note that the lender's return will be less than 4\% for a particular year only if the home falls in value. For example, if the home fell in value to $195,000 at the end of the first year, then the return will be 1.4\% (20.8\% x $195,000 = $40,560; $560 = $40,000 x 1.4\%).

\textsuperscript{20} Even though the equity share percentage increases by a constant nominal 4\%, inflation does not reduce the lender's return since the equity share percentage is multiplied by the home's nominal value, which increases along with the inflation.
(it was this effect that made lenders particularly keen on this form of finance in the late 1970's). 21

Furthermore, given that the cost of capital diminishes with the holding period, a SAM is likely to attract primarily those who wish to hold onto this form of finance for a long time.

In addition to outlining new forms of SAMs, the Fannie Mae Report provided a detailed analysis of how their use would enhance housing affordability without raising risk. It detailed how SAMs allow less well-off households to obtain homes with low down payments without requiring outsize bets on future house prices. 22 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% more valuable. 23 The report also provided survey evidence of high consumer interest based on a 1500-respondent survey conducted in February 2006. 24 The survey targeted households that felt it was at least “somewhat important” to buy their next home within the next five years. 25 It then illustrated the workings of a version of the SAMANTHA. Among all relevant demographic groups, 17% to 22% reported being highly likely to consider using it, while 62% to 67% reported being at least somewhat likely to consider its use. 26 It was explicitly preferred to the interest-only and negatively amortizing mortgages that played such a significant role in the recent housing crisis. 27

Because of their role in enhancing affordability in a low-risk manner, SAMs attracted particular attention in the current sub-prime crisis, 28 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. 29 Even academics chimed in, proclaiming that the “Great Moderation” was

21 See Ann Dougherty, Robert Van Order & Kevin Villani, Pricing Shared Appreciation Mortgages, 1 Housing Fin. Rev. 361 (1982).
22 Fannie Mae Report, note 1, at 226-27.
23 Id. at 227 tbl.6.
24 Id. at 222-23.
25 Id. at 222.
26 Id. at 237.
27 Id. at 226 tbl.5.
here, and with it a greatly dampened business cycle.\textsuperscript{30} With housing prices growing faster than incomes,\textsuperscript{31} 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 attractive it appeared when new mortgage products were made available allowing lower payments early in the amortization period in exchange for higher payments later.\textsuperscript{32}

We know how this 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 began to default, and foreclosures rapidly increased.\textsuperscript{33} An analogy to business and housing finance suggests how this turn of events induced interest in equity sharing. Consider a small business that borrowed just before the onset of an industry-wide slump. The business might find it impossible to pay the installments due on the initial debt. Provided the business was competent, viable on a day-to-day basis, and well-suited to running the business, every effort would be made to maintain the business as an ongoing operation. One way to accomplish this would be for the lender to allow some of its debt to be converted into equity in the business, which would be expected to return to profitability as the industry recovered. Another alternative would be for it 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.\textsuperscript{34}


\textsuperscript{31} See Shiller, note 29, at 13.

\textsuperscript{32} Among the new products were hybrid mortgages that combined floating and fixed rates with a relatively low initial interest rate, switching to an adjustable rate after two or three years. Interest-only mortgages had payments covering just the interest accruals in the first years, and negative amortization mortgages had payments that did not even cover the interest accruals. See John Kiff & Paul Mills, Money for Nothing and Checks for Free: Recent Developments in U.S. Subprime Mortgage Markets (IMF Working Paper 07/188, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1006316.

\textsuperscript{33} Gretchen Mortgenson, So Many Foreclosures, So Little Logic, N.Y. Times, July 5, 2009, at BU1.

\textsuperscript{34} See note 26.
III. Tax Obstacles

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 extraordinarily high, up to as much as 18%,\textsuperscript{35} making installment payments on mortgages prohibitively expensive. In that context the first general purpose SAMs were developed, allowing the interest rate to be cut significantly provided the borrower was willing to share appreciation with the lender.

Since SAMs sit in the grey area between debt and equity, in order to make these mortgages available to the public, it became necessary for originators to seek clarity from the Service regarding the federal income tax consequences to a mortgagor under a shared appreciation mortgage loan used to finance the purchase of a personal residence. In Revenue Ruling 83-51 the IRS ruled that regular interest payments during the life of the loan and final payments of contingent interest could be deducted for tax purposes.\textsuperscript{36} 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 SAMs were moved to the no rulings list—the list of issues on which it will not issue advance letter rulings or determination letters.\textsuperscript{37}

This has remained Treasury's position for the last twenty-five years.\textsuperscript{38} The result is that anyone who issues 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 to the market, consider the aborted effort of Bear Stearns to reintroduce SAMs into the United States in the 1990's. Given that tax uncertainties could not be resolved via a ruling, the brochures introducing these mortgages to borrowers included the following stark warning: "The application of the federal income tax

\textsuperscript{35} In the early 1980's, rates on conventional thirty-year mortgages ranged from about 12-18% over time. See www.federalreserve.gov/releases/h15/data/months/H15_MORTG_NA .txt(statistics); see also Rev. Rul. 83-51, 1983-1 C.B. 48, which contemplated a fixed conventional rate of 18%.


\textsuperscript{38} See Rev. Proc. 2009-3, 2009-1 I.R.B. 107. Section 3.01(21) provides: "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."
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.\textsuperscript{39}

\textbf{B. Unusually Punitive Treatment}

As a general proposition, in a well-designed tax system borrowing transactions should not affect the size of the tax base; that is, the interest that the lender must include should precisely offset 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). There is, however, a significant 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) generally are 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 otherwise might be on the cash method.\textsuperscript{40} 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, the accrual rules are relaxed. For example, 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 million, the lender must not be an accrual method taxpayer, and the lender cannot be a dealer with respect to the property sold.\textsuperscript{41} Even 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

\textsuperscript{40} IRC § 163(e)(1) (issuer's deduction); § 1272(a)(1) (holder's annual inclusion).
\textsuperscript{41} IRC § 1274A(c).
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. Thus 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 § 1.1275-4 of the regulations. 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 because the lender but not the borrower under a SAM is subject to these rules. Under § 1275(b)(2), the borrower cannot deduct the contingent interest until paid. Section 1275(b)(2) applies only to debt incurred in connection with the acquisition of "personal use property," which includes a home. 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.

To illustrate how SAMs are currently treated, consider the following example.

Example 3: Borrower B purchases a residence for $500,000 financed with a $100,000 down payment, a $300,000 conventional thirty-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) ten 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. Assume that the market rate of interest for thirty-year conventional mortgages is 6% and that B and L are both in the 35% bracket.

Under current law the SAM is a debt instrument and the amount payable thereon is contingent interest. L would be required to accrue interest income during the term of the SAM at the market rate of

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44 IRC § 1275(b)(2)(A). Personal use property means any property substantially all the use of which by the taxpayer is not in connection with a trade or business or for the production of income. IRC § 1275(b)(2), (3).
interest of 6% annually on $100,000. Over the ten year term of the SAM, \( L \) accrues $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, \( L \) includes 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. The total present value of \( L \)'s tax liability from this transaction is $22,371.

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. If the termination is triggered by a sale of the home for $700,000, \( B \) has a gain of $200,000, all of which is excludible. 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 which as of the date the SAM was issued is $19,099. In present value terms, \( L \)'s tax liability from this transaction is $3,272 more than \( B \)'s tax savings ($22,371 less $19,099). Thus, there is a net tax cost to this transaction.

If \( B \) refinances the SAM with a new mortgage secured by the home for $180,000, 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, \( B \) is treated as though she paid \( L \) the $80,000 of contingent interest, and is entitled to a deduction. Again there is a net tax cost because the present value of the lender's tax liability exceeds the present value of the borrower's tax savings. If \( B \) refinances the SAM with \( L \), however, the tax consequences are significantly different. Since \( L \) provides the funds to pay the contingent interest, the refinancing is not considered a payment and therefore \( B \) cannot deduct the contingent interest. Instead, \( B \) deducts the contingent interest on the SAM only as she pays the principal of the new mortgage. Four-ninths of all principal payments (80/180) will be considered interest due under the SAM. As this reduces the present value of the tax savings for \( B \) further, the net tax cost to the transaction increases.

### C. The Problem with Tax Costs

To see why this net tax cost on a SAM is problematic, consider the homeowner's alternative financing choice, a conventional home mortgage, with only fixed interest payable each year. In this case, the par-

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45 Reg. § 1.1275-4(b)(3), (4).
46 Reg. § 1.1275-4(b)(3)(iv), (6).
47 IRC § 121.
48 IRC § 163(h).
ties are treated symmetrically: The lender's annual income inclusions exactly match the borrower's annual deductions. As such, there is no net tax cost to the borrowing arrangement to the extent the parties are taxed at the same rate.\textsuperscript{49} The original-issuance SAM, however, contains a net tax cost even where the parties have the same tax rate due to the higher present value of the lender's inclusions. It is well recognized that taxing a transaction more heavily than its alternative(s) will make it less desirable on an after-tax basis, all else being equal.\textsuperscript{50} Furthermore, this tax cost remains problematic notwithstanding the fact that the SAM differs from the traditional home mortgage through its deferral of the payment time.\textsuperscript{51} As evidenced in the legislative history, the OID rules are premised on the notion that deferred-pay debt instruments generally should be taxed the same as current-pay instruments; that is, analyzed as if the borrower undertook new debt financing to make annual payments of the interest.\textsuperscript{52} In similar fashion, a cash method taxpayer generally can receive current deductions outside the OID rules without actually dipping into her pocket by explicitly borrowing new funds to make payment.\textsuperscript{53} At a deeper level, this unshackling of the reporting time from the payment date (to the

\textsuperscript{49} While there is a net tax cost if the lender has a higher marginal tax rate (and a net tax benefit where the borrower has a higher tax rate), such a possibility is obviously intended by Congress. In contrast there is no evidence that the net tax costs of SAMS was intentional. The drafters of § 1275(b)(2) did not have SAMS on their screens—the legislative history shows no such anti-SAM intent. Furthermore the borrower and lender on a SAM were treated symmetrically (deferral on both sides) until the contingent debt regulations were changed after the enactment of § 1275(b)(2), forcing earlier accruals by the lender.

\textsuperscript{50} See, e.g., David A. Weisbach, Line Drawing, Doctrine, and Efficiency in the Tax Law, 84 Cornell L. Rev. 1627 (1999).

\textsuperscript{51} The SAM also differs from the traditional home mortgage in its calculation of the payment amount, utilizing a contingent figure based on the appreciation. In this regard, note how symmetry also results in a actual ownership sharing arrangement whereby the original (sole) homeowner agrees with another party to share equally all the costs and benefits of home ownership, including any appreciation proceeds on sale. While the original homeowner would not receive any actual deduction for the portion of the appreciation ceded to her partner, she would receive a deduction equivalent (an implicit deduction) via her reduced share of the gain on sale. And while her implicit deduction would be deferred until sale, symmetry again results since her partner's income inclusion similarly would be deferred until the same time.

\textsuperscript{52} See Joint Comm. on Tax'n, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 108 n.7 (Comm. Print 1984). Although § 1275(b)(2) presents an exception to this notion, as discussed more fully below, there is no evidence that Congress wanted to discourage SAMS relative to conventional financing, especially given the fact that the asymmetry did not arise until Treasury amended the contingent regulations after enactment of § 1275(b)(2).

\textsuperscript{53} Generally the new borrowing must come from a new lender. See, e.g., Battlestein v. Internal Revenue Service, 631 F.2d 1182 (5th Cir. 1980). Some taxpayers, however, have had limited success even when they borrow the new funds from the same counterparty (that is, the recipient of the funds for which a deduction is claimed). See Noble v. Commissioner, 79 T.C. 751 (1982).
accrual time) generally comports better with the results under a theoretically true income tax, unburdened by liquidity and administrative concerns.54

The foregoing suggests that the correct response would be to permit the homeowner to take annual deductions for the contingent interest on the SAM under accrual concepts (like the lender who currently has to report income). As discussed more fully in Part IV, strict adherence to accrual concepts in this context presents difficulties given the contingent nature of the payout. As the growing body of literature focused on the overall tax consequences to all parties instructs, however, symmetry between both sides is more important than the choice between deferred or annual reporting. Such literature emphasizes how a tax detriment to one party can offset a tax benefit to another party, and how the tax rules can result in pretax pricing changes to the deal that can shift around the actual tax burdens.55 The literature typically considers situations where one party receives favorable treatment, emphasizing how the situation is truly tax-favored only absent an offsetting detriment to another party.56 Although the SAM treatment differs from these other scenarios in that there is no favorable treatment to either party, it is the flip side to the analysis. Here, one party receives unfavorable tax treatment that is not offset by unusually favorable treatment of the other side. As such, we can rectify the extra tax cost of the SAM by either permitting the homeowner to accrue annual deductions or by deferring the lender's income inclusions. We address in Part IV which symmetrical reform options (deferred or annual reporting) would be most sensible.57

54 See David Hasen, The Tax Treatment of Advance Receipts, 61 Tax L. Rev. 395, 442-43 (2008) (“accrual method is an effort to approximate that ideal of imposing tax only as when true income arises . . . . The cash method, of course, is a still courser approximation of true income, designed in part to make allowance for the fact that liquidity might not always attend income.”).

55 See, e.g., Ethan Yale, Investment Risk and the Tax Benefit of Deferred Compensation, 62 Tax L. Rev. 377 (2009) (employers can decrease the pretax compensation on non-qualified deferred compensation to take into account the cost of their matching deferred deduction when the employee’s income is successfully deferred); Michael S. Knoll, The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income, 50 William & Mary L. Rev. 115 (2008) (similarly, in the context of carried interest, the favorable tax treatment of the fund manager might be offset by adverse treatment of investors).

56 See Yale, note 55, at 394; Knoll, note 55, at 125-27.

57 It is an interesting question whether it is the homeowner or the lender who is overtaxed under the current SAM treatment. It is the homeowner who loses out relative to the traditional mortgage, while it is the lender who is disadvantaged relative to a pure-equity sharing arrangement. And since the SAM shares some characteristics with both the traditional mortgage and the equity sharing arrangement, we might have some difficulty in determining which party receives the harmful treatment in the first instance. Fortunately, the literature focused on the overall tax consequences to all parties instructs that we need not
D. Incoherence

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. 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 it is likely (although not certain) that SAMs are treated better for tax purposes than conventional financing. 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.58

We 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 probably will 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 use the following variation of our previous example.

Example 4: Several years ago, $B$ took out a conventional thirty-year mortgage. When the balance (and the adjusted issue price) on the mortgage is $400,000, $B$ refinances the mortgage with a new conventional thirty-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. At the end of ten years the home is worth $700,000. Assume throughout that the applicable federal rate (AFR) is 4.5%.

resolve such inquiry to understand the problems with the current SAM treatment. Based on such literature, we know that one and possibly both parties will receive a lesser after-tax amount than under conventional financing (with such breakdown determined based on the supply/demand curves for funding, negotiations, and the like).

58 See Knoll, note 42, at 1374, for the lack of any legislative history behind the deferral of personal use deductions, and id. at 1360-62, for the symmetrical treatment of SAMs (deferral on both sides) under the original proposed §1.1275-4 regulations. For the legislative history of IRC 1275(b)(2), see 1984 General Explanation, note 52.
This transaction is a debt-for-debt exchange between the borrower and the lender. In such an exchange, if there is a significant modification of the debt instrument, the exchange is a taxable event for both parties. We are confident that there has been a significant modification and that both parties are taxable. The issue price of the "new" debt instrument generally is determined under § 1274. Under this provision, the issue price would be the lesser of the noncontingent principal and the present value of all noncontingent payments (discounted back at the AFR). The contingent interest component is ignored, at least initially. The issue price for the new instrument is therefore $400,000.

59 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. Reg. § 1.1001-3.

60 Converting a conventional mortgage into a SAM generally should be treated as a significant modification. 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." Reg. § 1.1001-3(e)(1). The regulations then go on to provide some specific categories such as significant changes in the yield to maturity or the payment dates. Reg. § 1.10001-3(e)(2), (e)(3). Application of these specific categories to the SAM modification might be less than certain as the contingencies prevent an upfront determination of, for example, 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, A Guide to the Tax Treatment of Contingent Payment Debt, 56 NYU Inst. § 5.07 (1999) (change from a fixed rate to a contingent instrument is a significant modification due to the change in the yield to maturity).

61 This assumes that the debt instruments are not publicly-traded. Section 1274 generally applies where new debt is issued in exchange for property if neither the new debt nor the exchanged property is publicly traded. IRC § 1274(c)(3)(D). 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. IRC § 1274(e)(3)(C). If so, the issue price would equal the "stated redemption at maturity," which generally includes all payments other than "qualified stated interest." IRC § 1273(b)(4); Reg. § 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. Reg. § 1.483-4(b)(Ex. 1) (contract provided for $200,000 principal plus contingent interest capped at $50,000).

62 Reg. § 1.1274-2(g).

63 This is determined by taking the lesser of $400,000 (the noncontingent principal) or $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 ten years using a discount rate of 4.5%).
When a SAM is issued as part of a refinancing, the parties are no longer governed by § 1.1275-4(b), but rather by § 1.1275-4(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 refinanced SAMs it operates in a bizarre fashion. As shown below, the regulation seemingly allows the lender of a refinanced SAM to defer some of the contingent income beyond the payment date.\(^6\)

This regulation treats all noncontingent payments, both principal and interest, as a single instrument and takes into account contingent payments only if and when they are 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 Example 4 when the $80,000 contingent interest is paid ten 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%) is treated as additional principal. It is not entirely clear how either the borrower or the lender should treat this amount, which we refer to as "additional principal."

As a result of the workout/refinancing, \(B\) may have cancellation of indebtedness income (COD).\(^5\) This occurs whenever the issue price of the new instrument is less than the adjusted issue price of the old one. 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. The borrower would have to reduce the basis in the home by the unreported COD income.\(^6\) If 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. Starting in 2013, however, the homeowner would have to report the COD absent a legisla-

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\(^6\) As shown below in this Section, this results since the refinanced SAM is issued in connection with conventional financing that can extend significantly beyond the payment date of the contingent SAM. As such, the bizarre result does not occur in transactions where the contingent payment date does not significantly predate the payment of other principal.

\(^5\) COD income is the excess over the adjusted issue price over the repurchase price. Reg. § 1.61-12(c)(2)(ii). To determine the repurchase price where the old debt is satisfied by new debt, these regulations cross reference § 108(e)(10), which 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.

\(^6\) IRC § 108(h)(1).
tive extension of the COD exemption, or unless the owner separately qualified for the insolvency or bankruptcy exception.67

The tax consequences to B of the newly issued SAM are fairly straightforward 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, which raises significant tax uncertainty.

There are at least three plausible ways to treat it. First, it could be added to B's basis in the residence. 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.68 We believe this is the most appropriate way to character-

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67 The Mortgage Forgiveness Debt Relief Act of 2007 generally would allow the borrower to avoid reporting any such COD income, but only until tax years 2012. IRC § 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).

Technically, 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 noncontingent 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 § 1275(b) rules (that is, when issued originally for cash under § 1.1275-4(b) of the 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 the sale either is exempt or taxed at favorable rates. IRC §§ 1(h)(1), 121. 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 § 163(h)(3)(B).

68 Under § 1.163-7(c) of the regulations, a 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 § 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 § 1.1275-4(c) bifurcation approach (and alternatively, without the § 1.1275-4(c) bifurcation, the full contingent amount would be deductible interest without regard to the repurchase premium analysis). The potential technical problem, though, is that the § 1.163-7(c) regulation refers to the issue price of the new debt, and § 1.1274-2(g) excludes the contingent amount from the issue price calculation. Section 1.1275-4(c) of the regulations unfortunately does 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 § 1.1275-4(c)'s focus on the treatment of a buyer who purchases new property for a contingent debt instrument. In this regard, note that § 1.1275-4(c) provides in that context that the buyer gets additional basis in the purchased property for the principal portion of the contingent payment. In our context, if the owner were denied an interest deduction for the principal portion of the contingent payment she presumably then in-
ize the 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 thirty-year mortgage. On our facts, it seems to increase her basis in the home. But unlike the regulation's example, the owner here is not paying additional contingent amounts to the seller of the home, but rather to the third 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 the 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 the 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 until 2012). 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 67 and accompanying text. For a practitioner's attempt to make some sense of these rules outside the home mortgage context, see Asofsky, note 60, § 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 (that is, 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 taxpayer's 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 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, § 1.163-7(c) of the regulations further refines 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 applies. 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 (for example, 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 approach under § 1.1275-4(c) of the regulations is also somewhat inconsistent with the COD analysis above. The COD calculations treat the old debt as exchanged for new debt with principal based only on the noncontingent amounts. In contrast, § 1.1275-4(c) retroactively treats the contingent instrument as having a principal amount based on the present value of all payments, including the contingent payments. As such, one 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.
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).\footnote{Section 1.163-7(c) of the regulations provides a general rule that the retirement premium in a § 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 the homeowner context. Thus, the homeowner presumably can deduct any retirement premium only upon the later of payment or the OID-like accrual over the full thirty-year term of the entire debt instrument. On our facts, though, the owner should be able to deduct virtually the entire premium when paid. This results since the contingent return on the SAM (6.05%) 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, a more significant amount of the premium presumably would have to be amortized over the full thirty-year term.}

The tax consequences to the lender are remarkably different from the treatment of the lender of the originally issued SAM. 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.\footnote{This assumes that the debt is not publicly traded. See note 61. This also assumes that anti-abuse rule of § 1.1275-2(g) of the regulations does not apply. See note 75.} The exact treatment, however, is uncertain although some results are clear. On the facts of Example 4 L will have to report the 6% interest each year under its normal method of accounting. In addition, when the SAM terminates, L must report as interest the amount of the contingent payment characterized as interest under § 1.1275-4(c), here, $28,486. The remaining issue is how and when L 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.

From L's perspective, the workout/refinancing is treated as a taxable exchange and L's gain or loss is equal to the difference between the amount realized (that is, the sum of the new issue price plus the fair market value of the contingent payment)\footnote{Reg. § 1.1001-1(g)(2).} and the adjusted issue price of the old instrument. It is interesting to note that L might have a taxable gain on this exchange even in cases where L has an economic loss. Initially, this is a result of the way the new issue price is calculated.\footnote{The issue price of the noncontingent amounts equals the lesser of the stated noncontingent principal or the present value of all noncontingent payments, discounted back at the low AFR. Reg. § 1.1274-2(g). 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 63. Without the $100,000 principal underlying the SAM, the issue price would have been only $300,000. And as discussed in Imaged with the Permission of N.Y.U. Tax Law Review}
ately. If there is a gain, then, unless \( L \) is a dealer, or if the debt is publicly traded, \( L \) is entitled to report that gain using the installment method.\(^{73}\) In general, \( L \)'s selling price 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 \( L \) receives principal payments (including both the noncontingent principal payments and the additional principal). Applying these rules to Example 4, \( L \)'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 \( L \)'s adjusted basis in the old debt is also $400,000, \( L \)'s gain on the exchange will equal the additional principal. The only question is when that gain should be reported.

the text below, \( B \)'s amount realized on the sale includes both such heightened issue price plus a separately determined amount of principal on the contingent payment itself.

\(^{73}\) IRC § 453. Absent § 453, \( L \) must report gain or loss at the time of the exchange based on an amount realized equal to the sum of the fair market value of any contingent payments at such time, plus 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 § 1.1275-4(c) of the regulations and the more general § 1.1001-1(g) of the regulations. Under § 1.1275-4(c), 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 § 1.1001-1(g) trumps § 1.1275-4(c) regarding the lender's exchange gain or loss since § 1.1001-1(g) is more specific as to this issue, and Treasury's explanation of § 1.1275-4(c) 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 § 453 does not apply. See, e.g., Reg. § 15A.453-1(d). \( L \) presumably also must account for the difference between the principal portion of the contingent payment under § 1.1275-4(c) of the regulations present value bifurcation, and 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 § 1.1001-1(g) and § 1.1275-4(c) 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 three years, increased to six years for substantial understatement, open forever for fraud. § 6501(a), (c), (e)).

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 § 1.483-4 of the regulations (rather than § 1.1274-2(g) of the regulations), 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 at note 61, however, it is not clear when, if at all, an uncapped SAM would fall outside of § 1274.

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It is not at all clear when $L$ should report that gain under § 453—the provision was not designed for transactions like this.\(^7^4\) 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 $L$. If viewed as interest, this would seem sensible: It would essentially put $L$ 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 during which payments are received. On our facts, that would mean that $L$ would be entitled to report most, or all, of the $51,514 gain not on receipt but over the remaining twenty years of conventional mortgage.\(^7^5\)

\(^7^4\) If § 453 does not apply, 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 73. For instance, with a contingent value of $40,000, $L$ 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, $L$ would seem to have additional exchange gain of $11,514: that is, 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 Year 10, the year in which the amount can be determined. Such approach might seem particularly sensible in this 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).

\(^7^5\) Since there is no cap on the amount payable under the SAM, the fixed period rules of § 15A.453-1(c)(3) of the regulations 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, $L$ would recover $13,333 of basis for each year of the thirty-year loan ($400,000/30). Since the noncontingent principal payments for each of the first ten years are all significantly below that amount, $L$ not only would avoid reporting any gain on those payments, $L$ seemingly could avoid reporting any gain on the Year 10 contingent principal as well since 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 $L$ would have about $68,000 of carriovers from the Years 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 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.” Reg § 15A.453-1(c)(3)(i). It thus seems that $L$ 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. § 15A.453-1(c)(7) (example of the “substantial distortion” rules). For instance, if the contingent payment had an expected value of say $40,000, $L$'s basis could be allocated on the assumption that there would an additional principal payment of $40,000. Such adjustment would not seem to change the above
We do not believe this to be very sensible as the income can be deferred until well beyond both the payment and accrual times.\textsuperscript{76}

In sum, the workout scenario should further the impetus for change. First, while not necessarily subject to additional tax burdens, refinanced SAMs still face uncertainty and complexity roadblocks, much like original issuance SAMs. As in other areas, legal uncertainty hinders development of new financial markets.\textsuperscript{77} Moving beyond these results, though, since even with such adjustment, $L$'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 Service might invoke the Reg. § 15A.453-1(c)(7) "substantial distortion" rules to accelerate the reporting of the gain. Under these rules, the Service 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 Service's more exact method. Query whether the "twice as fast" rule would be satisfied on our facts. Even if successfully invoked, $L$ probably could still defer most of the gain until—and beyond—the Year 10 payment date. A reasonably fair result might require $L$ 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 ten years, $L$ 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, $L$ still would report only $13,322 of the $51,514 gain by the end of ten years. A separate anti-abuse rule involving the § 1.1275-4 of the regulations needs to be considered as well. The Service 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, § 1.1275-2(g)(Ex.2) states that the Commissioner can apply § 1.1275-4(b), rather than § 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 in our example. For an extreme example that presumably would be caught by the § 1.1275-2(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.

As discussed at note 54, income generally should be reported at accrual, although liquidity and administrative concerns might justify deferral until payment in certain cases. Here, though, the deferral can extend from the accrual time until well after the actual payment date.

\textsuperscript{76} As discussed at note 54, income generally should be reported at accrual, although liquidity and administrative concerns might justify deferral until payment in certain cases. Here, though, the deferral can extend from the accrual time until well after the actual payment date.

\textsuperscript{77} See Alan N. Rechtschaffen, Foreword: International Symposium on Derivatives and Risk Management, 69 Fordham L. Rev. 13, 14 (2000) ("Risk managers must be able to engage in derivatives transactions without fear that legal uncertainty will impact their risk management decisions. A cloud of legal uncertainty has hung over the OTC derivatives markets in the United States in recent years, which, if not addressed, could discourage innovation and growth of these important markets and damage U.S. leadership in these arenas by driving transactions off-shore."); Jon Hilsenreth, David Wessel & Sudeep Reddy, Obama to Reappoint Bernanke as Fed Chief, Wall St. J., Aug. 25, 2009, at A1 (quoting Richard Berner, chief economist at Morgan Stanley, regarding the impact on the marketplace of the reappointment of Federal Reserve Chair Bernanke: "It reduces uncertainty, and the markets abhor uncertainty.").
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. In addition, having provided such more favorable treatment, the government must now police the distinction between a refinanced SAM and an original issuance SAM.\textsuperscript{78}

IV. RECTIFYING TAX TREATMENT OF SAMs

We outline three possible methods of rectifying the tax treatment of SAMs. The first is to reinstate pre-1996 law. Treasury could essentially reinstate pre-1996 law by amending the contingent interest regulations to exempt SAMs. In so doing, they also would 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. Alternatively, Congress could allow the borrowers to accrue interest by repealing §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. This would match the results where the debt was not for personal use property, for example, for use in a trade or business or for the production of income.\textsuperscript{79} Finally, 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.

A. Reinstate Pre-1996 Law

Since the rules relating to contingent interest under §1.1275-4 of the regulations were promulgated under authority granted to Treasury, it certainly has the power to create an exception from them if it felt it was 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 treating the loan transaction fairly.

\textsuperscript{78} See, e.g., the anti-abuse rule of § 1.1275-2(g) of the regulations, discussed at note 75.

\textsuperscript{79} See note 44 (regarding the reach of § 1275(b)).
SAMs, which were rarely issued during the 1990'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.\textsuperscript{80}

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 has a net tax cost associated with the instrument.\textsuperscript{81} Since there is no apparent reason that the use of SAMs should be discouraged, Treasury should exempt them by crafting a very narrow exception. We propose a precise definition of a SAM to be exempted from § 1.1275-4(b)-(c) of the regulations.

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.\textsuperscript{82} Second, it must enable superior SAMs to be developed that better mediate gains from trade, such as the SAMANHTHA described in Part II. We propose the following definition:

1. Both the borrower and the lender intend no more than debtor/creditor relationship.
2. The borrower is an individual whose principal residence\textsuperscript{83} secures the SAM;
3. The borrower and the lender are unrelated (or, in the alternative, the lender is a financial institution).
4. The borrower is solely responsible for taxes, insurance, and the like. 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 the value of the underlying residence.

\textsuperscript{80} See Section III.B.
\textsuperscript{81} As discussed above, § 1275(b)(2) applies only to personal use property. With the disallowance of personal interest other than qualified residence interest, the asymmetry arises only for residence interest. See § IRC 163(h).
\textsuperscript{82} As evidenced by Revenue Ruling 83-51, the government has legitimate concerns over taxpayers treating equity sharing arrangements as debt, perhaps to generate interest deductions for the purported "borrower." Note that while there would be an offsetting income inclusion to the purported "lender," a net tax advantage would result where the "borrower's" marginal tax rate exceeded the "lenders." With that in mind, we are sensitive to maintaining our limited focus on just eliminating the harsher treatment of SAMs relative to conventional financing.
\textsuperscript{83} We limit the definition to principal residences because of our limited focus on eliminating tax impediments to the use of SAMs for purchases of principal residences (and not for vacation homes of other real estate).
6. In all events, the 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 the Fannie Mae Report, in which a decline in house prices can reduce indebtedness below the original loan value.\(^8\)\(^4\) While it would enhance gains from trade to allow for sharing of losses, the Service would be likely to revisit the issue of whether a SAM with loss-sharing features is best seen as debt or equity. Hence, we do not consider this case. Note 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 \(L\) would not include the contingent interest income until termination. At that time, whether or not paid,\(^8\)\(^5\) \(L\) would have income equal to a percentage of the appreciation in the residence. This would eliminate the timing differences between the borrower and the lender (except in the limited case of a refinancing with the same lender), and thereby have the effect of eliminating the disadvantageous treatment of SAMs.

In the workout context, exemption from § 1.1275-4 (both (b) and (c) of the regulations) would have the additional advantage of removing the uncertainty over the homeowner's deductibility of the "additional principal" portion of the contingent payment.\(^8\)\(^6\) The regulatory exemption would have no impact on the COD analysis.\(^8\)\(^7\)

With respect to \(L\) in the refinance context, as exemplified above, § 1.1275-4 of the regulations does not necessarily harm, and might even help, the lender if it can use § 453. This results since the "interest" portion of the contingent payment is not reported until paid, and 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. There is some uncertainty, however, over the actual reporting time.

\(^8\)\(^4\) See discussion accompanying notes 15-17.

\(^8\)\(^5\) The contingent amount might not be paid due to a refinancing with the same lender.

\(^8\)\(^6\) 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. While this also presents the possibility of some asymmetry, this is a relatively narrow context involving a refinancing with the same lender. If desired, the homeowner could accelerate the deduction by refinancing with another bank.

\(^8\)\(^7\) Apart from this specific context, the Service might want to consider revisiting this area and dealing with the phantom COD income.
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, 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. 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).

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.

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 market rate.

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 given the difficulties of the legislative process. 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 contingent inter-

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88 This would result if the lender is a dealer or if there was public trading of the debt. See note 73 and accompanying text.
89 See note 72 and accompanying text (explaining such double counting).
90 Alternatively, the lender's total amount realized could be set at the fair market value 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 approach of § 1.1001-1(g) of the regulations.
91 As discussed at note 81, with a deduction for personal interest now generally disallowed, such repeal would impact only qualified residence interest.
est that will not be paid for several years—or perhaps not at all—as unduly complicated. Somewhat related, 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, suppose that the home does not appreciate in value. Under this alternative, over the term of the SAM the borrower will have interest deductions. But since the home did not appreciate in value, and the borrower will not have to pay the lender any contingent interest, the borrower 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. 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).

Finally, as regards the interest component, the regulations provide a special rule deferring both the inclusion to the lender and the deduc-

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92 See Reg. § 1.1275-4(b)(6) (where contingent payment is less than projected amount, issuer reduces interest expense for the year, and then reports ordinary income for any remaining excess).

93 For a discussion of the relevant term in the SAM context, see note 69 and accompanying text.

94 As discussed in Section III.D, 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 Section IV.B, § 1275(b)(2) repeal by itself would not provide symmetry between the lender and borrower.
tion to the borrower until payment. Repeal of § 1275(b)(2) therefore would have no impact on the interest component.\textsuperscript{95} 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 of the contingent payment under the § 1.1275-4(c) regulations. As highlighted in Part III, 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 § 1275(b)(2) 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.\textsuperscript{96} 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.

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. Focusing on just SAMs, this approach might be the most attractive alternative. There are, however, collateral consequences that should be taken into account, as well as the possible impact this alternative might have on the characterization of other instruments. In addition, as noted below, equity characterization might treat the SAM less favorably in certain ways than conventional financing. This would be at odds with our goal of avoiding harsher taxation of SAMs than conventional financing.

\textsuperscript{95} There is no need for reform on this component since there is neither a timing mismatch between lender and borrower, nor any threshold concern as to deductibility (in favorable contrast to the principal component).

\textsuperscript{96} As discussed above, even with repeal of § 1275(b)(2), doubts would remain as to the deductibility 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.
If the SAM is considered an equity interest, in Example 3 then both $L$ and $B$ would be considered to have equity interests in the home. $B$'s basis 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 straightforward: $B$ 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. $L$ 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.

Under this characterization, $B$ is not treated as well as under the debt characterization, because if the SAM is characterized as a debt, $B$ would have $80,000 more gain on the sale that would be 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 $B$ would not be entitled to if the SAM is characterized as equity. To such extent, the SAM would then receive less favorable treatment than under conventional financing, making it comparatively less attractive.

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

Finally, if $B$ refinances the SAM by obtaining a conventional thirty 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, $L$ may be entitled to treat the transaction as a sale and report the $80,000 over time under the installment rules since $L$ does not receive the proceeds until later (unlike the above third party refinancing).

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.
These two specialized Code areas evidence a more general bias in favor of less dramatic corrective changes in order to minimize any unintended consequences which would make the SAM less tax attractive than conventional financing.

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). Consider first the COD consequences. The phantom COD issue generally should be eliminated since there should be a bifurcated exchange of part of the old debt for new debt with adequate stated interest, and the remaining old debt for equity taken into account at its full value. 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 of its basis in the home. Assume, for instance, that the home in Example 3 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. The homeowner would have a $25,000 loss on sale, but such loss would not be recognized for tax purposes. The end result is a permanent loss of basis in the home equal to the amount of the disallowed loss. This could result in the homeowner reporting phantom

97 Under the current debt treatment of SAMs, foreign lenders who receive the contingent SAM payment from the borrower can avoid negative tax consequences under § 897 since the contingent payment is treated as interest. See Reg. § 1.897-1(h)(Ex. 2); Jeffrey L. Rubinger, Using Shared Appreciation Mortgages to Avoid FIRPTA, 80 Fla. Bar J. 40 (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 70-75 and accompanying text. For a potential concern for REMIC investors, see, e.g., IRC §§ 860D, 860G (predicating favorable REMIC status on the holding of only "qualified mortgages" and "permitted investments").

98 Note that there was no phantom COD on these facts since there was sufficient fixed principal and interest.

99 This is not to say there could not be COD depending 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.

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

101 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.

102 IRC § 165(c). The homeowner's basis in the retained 75% of the home would be only $375,000. Contrast the example outside the workout context where the homeowner has a $400,000 basis in the home apart from the SAM piece.
gain on the ultimate sale of the home where the gain on sale exceeds the exclusion amount under § 121. This would make the SAM less tax attractive than conventional financing, all else equal.

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 some old debt for new debt, with some old debt for new equity exchange. Such bifurcation therefore removes the "double counting" of the contingent payment discussed above.\textsuperscript{103} As highlighted above, this elimination of the phantom gain could be adverse or beneficial to the lender depending on whether § 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 recharacterization as equity, we do see this as an unlikely outcome. The underlying problem 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. It is likely that the principal reason that Treasury has been unwilling to issue rulings on SAMs for the last twenty-five 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 longstanding position and characterize SAMs as equity, the implications of this decision could negatively impact other areas such as the treatment of REMICs.\textsuperscript{104} 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 markets. Unfortunately,

\textsuperscript{103} Recall Example 4 where L's amount realized equaled $451,514, of which $151,514 was attributable to the SAM principal plus contingent interest. See note 72 and accompanying text. Under the bifurcated exchange, $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.

\textsuperscript{104} See discussion at note 97 and accompanying text.
current tax rules make it essentially impossible to develop SAM markets in the United States. We propose very limited regulatory changes that would liberate SAM markets, while having few if any consequences outside this narrow setting.