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VIEWPOINT
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In this article, Feiring and Zucchetto argue that Treasury and the IRS should make shared appreciation home mortgages exempt from contingent payment debt instrument rules to encourage lenders and improve the interest rate environment.

Shared appreciation home mortgages (HSAMs) are intended to facilitate individual homeownership by allowing borrowers to pay current interest at below-market rates in exchange for sharing some of the home appreciation occurring between the time the mortgage loan is originated and an identifiable event or a definitive future time. Under ordinary circumstances, the lender and borrower are unrelated, independent parties, and it can be presumed that the lender expects the value of the shared appreciation payment to make up for, or even exceed, the difference in value between the payments received at below-market rates and the value of the payments had they been received at regular rates. Despite the economic benefit of this deferral for mortgage borrowers and the expectation of market (or better) returns for mortgage lenders, the latter are often unwilling to make HSAMs.

The IRS and Treasury can and should change this situation so borrowers can once again take advantage of HSAMs, especially in the current environment.

One reason that lenders may be reluctant to make HSAMs could be the concern that HSAM federal income taxation is governed by the rules that apply to other types of contingent payment debt instruments (CPDIs).[1] As a matter of cash flow, the HSAM lender receives below-market current interest payments and a single lump sum (if any) after several years. Under the CPDI regulations, however, the HSAM lender must accrue and pay tax currently on interest computed at a "comparable yield," which can be expected to exceed the actual interest payable at a below-market rate. After accruing income and paying the tax on it before the income is received, the HSAM lender then gets the shared appreciation payment. At that time, the HSAM lender either (1) receives an amount equal to the previously accrued and taxed income, which means the HSAM lender has paid tax on an accelerated basis, (2) receives an amount less than the previously accrued and taxed income, which means the HSAM lender has paid tax on an accelerated basis and can claim an offsetting deduction on a deferred basis, or (3) receives an amount greater than the previously accrued and taxed income, which, depending on

[1] *See* Andrew Caplin, Noel B. Cunningham, and Mitchell Engler, "Rectifying the Tax Treatment of Shared Appreciation Mortgages," 62 *Tax L. Rev.* 505 (2009).

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the amount of the shared appreciation payment in excess of the income previously accrued and taxed based on the comparable yield, may provide some deferral of tax.[2]

The CPDI rules can, therefore, create the risk of negative tax arbitrage to an HSAM lender. It is possible that this risk of negative tax arbitrage has turned lenders subject to the regular original issue discount rules away from making HSAMs. Also, the risk of negative tax arbitrage to lenders is not balanced by any tax benefit to borrowers. Because most home borrowers are cash-basis taxpayers, and an HSAM, by definition, is used to carry or acquire personal property, they cannot deduct contingent interest (the shared appreciation amount) until paid. Presumably, the difference between interest actually paid and interest computed at the comparable yield is never paid and never deductible.[3]

Given the potential benefit of HSAMs to homebuyers and the unbalanced income tax treatment between borrowers and lenders, it would seem difficult to persist in applying the CPDI rules to HSAMs. It is believed that not subjecting HSAMs to the CPDI rules, even if only temporarily, or clarifying that HSAMs are not intended to be subject to the CPDI rules, would encourage more home mortgage lending, which could be helpful in the current interest rate environment. That targeted temporary suspension of the CPDI rules, or their clarification in the case of HSAMs, could be justified by policy considerations (the current pressure on borrowers) but it could also be justified for technical reasons, including the CPDI rules themselves and their potential adverse effect on real estate investment trusts and real estate mortgage investment conduits. Finally, as a historic matter, the CPDI treatment of HSAMs does not reflect the government's original approach to HSAMs. That approach changed over time, which again would suggest that a different treatment is possible.

Before the current CPDI rules were issued, HSAMs were subject to income tax accounting rules that did not require any HSAM appreciation payment (or comparable yield) to be projected and taken into income annually as OID. To the contrary, under a 1983 revenue ruling on HSAMs (Rev. Rul. 83-51, 1983-1 C.B. 48) the REIT provisions concerning shared appreciation mortgages (SAMs) added by the 1986 Tax Reform Act[4] and the first two sets of OID regulations for CPDI,[5] HSAM payments would not be projected or accrued currently based on a comparable yield or taken into account before being fixed. Although it is arguable that the current CPDI regulations have changed that treatment for HSAMs, the mechanics of those rules (especially the definition of "comparable yield") and their failure to address the treatment of HSAMs under the REIT statute and REMIC regulations indicate that HSAMs were not intended to be CPDIs.

Initially, the IRS and Treasury addressed the borrower side of HSAMs in Rev. Rul. 83-51, which was issued at a time when home mortgage interest rates were hitting historic highs. As contemplated by the facts of the revenue ruling, regular interest rates were as high as 18 percent annually. The revenue ruling explains that by borrowing under an HSAM, a homebuyer could pay interest regularly (monthly) at a below-market rate, such as 12 percent annually. In return, the homeowner would pay a share of the home's appreciation occurring between the loan origination and the earliest of (1) the loan payoff, (2) the sale of the home, or (3) 10 years from the origination. The revenue ruling concludes that the regular interest payments and the shared appreciation payment could be deducted as interest in the year paid.

Rev. Rul. 83-51 did not address the lender's tax consequences of an HSAM, but the first set of proposed CPDI rules does. Under the first set of proposed rules for CPDIs (LR-189-84), published in the *Federal Register* for April 8, 1986, a SAM issued for cash or publicly traded property would be split into two components: the non-contingent payments and the contingent payments. The non-contingent payments would be treated as a separate, non-contingent debt instrument, having an issue price equal to the issue price of the overall

[2]Reg. section 1.1275-4.

[3]Reg. section 1.163-7 and section 1275(b)(2).

[4]Section 856(j).

[5]T.D. 8517 and T.D. 8674.

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debt. The contingent payments would be treated entirely as interest deductible by the issuer and includable by the holder for the tax year in which the payment became fixed. Under these regulations, the HSAM described in Rev. Rul. 83-51 would be split into two components: a straight debt component having a principal balance equal to the initial loan principal balance of the entire loan, paying interest at 12 percent annually, and a contingent shared appreciation component which would be treated as additional interest paid when due under the contract (the earlier of: payoff, sale, or the end of 10 years). Inclusion and deduction of the HSAM appreciation component was deferred and essentially mirrored the timing of the deduction for the borrower in Rev. Rul. 83-51.

The next set of proposed rules for CPDIs (FI-189-84), published in the *Federal Register* for February 28, 1991, revised the initial rules. CPDIs were again split into two separate components except that the issue price of the non-contingent component was determined under the investment unit rules. More importantly, the contingent payment component would no longer be automatically characterized as interest but instead in accordance with its economic substance. Under this second set of proposed regulations, entitlement to a SAM payment could be treated as an option or some other kind of property right.

An example in these revised, proposed regulations posited a five-year debt instrument issued for a cash payment of $1 million. Until maturity, the debt instrument was to make non-contingent, semiannual interest payments based on a 9 percent annual rate, which rate was based on the midterm applicable federal rate. At maturity, the debt instrument was to make a non-contingent payment of $1 million and a contingent payment equal to $1 million multiplied by the percentage increase in a public stock index over the five-year term of the instrument.

Under this second set of proposed regulations the non-contingent payments were characterized as a debt instrument with an issue price reflecting the regular interest payments and a $1 million redemption price. The contingent payments were characterized as a cash-settled index option issued for a premium equal to $1 million minus the deemed issue price of the non-contingent payments. Again, the inclusion and deduction of something like an HSAM appreciation component would be deferred even if it were not necessarily characterized as the receipt of interest.

The REMIC regulations were modified in the same year that this second set of CPDI regulations was proposed.[6] Although they do not address the treatment of HSAMs directly, they can be seen as adopting the deferral model of HSAM income taxation. Specifically, these REMIC regulations explain that some rights that would ordinarily prevent a mortgage loan from qualifying as a REMIC asset could be retained by a sponsor. This would allow the mortgage loan to then be contributed to a REMIC so long as the mortgage loan (without the rights retained by the sponsor) would then pay interest at a REMIC-qualifying fixed or variable rate. Specifically, reg. section 1.860D-1 says that:

> If an obligation with a fixed principal amount provides for interest at a fixed or variable rate and for certain contingent payment rights (*e.g.*, a shared appreciation provision or a percentage of mortgagor profits provision), and the owner of the obligation contributes the fixed payment rights to a REMIC and retains the contingent payment rights, the retained contingent payment rights are not an interest in the REMIC.

If a shared appreciation right can be stripped and leave an ordinary fixed or variable rate mortgage loan, the indication is that the contingent payment right can be accounted for separately and no longer affect the remaining instrument. The indication is that the comparable yield was no longer part of the mortgage loan held by the REMIC and that the stripped right could go untaxed until the shared appreciation payment, if any, was made or at least fixed.

Section 856(j), which establishes rules for REITs that make or acquire SAMs appears to take a similar view: Appreciation payments should be treated separately and taxable when paid or fixed. It was added to the code by TRA 1986 because

[6] T.D. 8366, amended by T.D. 8458.

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Congress believed that the treatment of SAMs should be clarified for purposes of the REIT income requirements.[7] In general, Congress believed that for these purposes it was appropriate to treat the income from the shared appreciation provision as gain from the sale of the related real property, indicating, again, the contingent payment right could be accounted for separately in the future and without affecting the remaining instrument.

Many comments on the second set of proposed CPDI regulations convinced the IRS and Treasury to propose a third set of CPDI provisions.[8] The commentators were most concerned that deferring the deduction and inclusion of the contingent payment to the year in which the contingent payment became fixed allowed for substantial backloading of interest income. In addition, the commentators doubted how easy it would be to both calculate the size of contingent payments and to characterize the entitlement to contingent payments as definitive types of financial instruments.

It is under this final set of regulations[9] that OID is accrued and reported annually based on the comparable yield, which for a debt instrument is the yield at which the issuer would issue a fixed-rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument (the comparable fixed-rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions (but of course without the contingent payment). Positive or negative adjustments to the amounts included based on the comparable fixed yield would be made when the amount or amounts of the contingent payments were known.

Presumably, if the current CPDI rules were applied to the HSAM in Rev. Rul. 83-51, the lender would have to annually accrue and report interest at 18 percent (the comparable yield) while only receiving interest at 12 percent and could adjust these accruals only when the single contingent payment was fixed.

There are reasons to doubt whether it is appropriate to apply the CPDI comparable yield rules to an appreciation right of an HSAM. HSAMs are for individuals that cannot acquire a home if compelled to pay interest at a regular fixed rate, which is the entire reason for the HSAM alternative. An HSAM appreciation right does not measure general market movements of residential real estate; an HSAM appreciation right gives a lender an economic interest in the value of the individual, financed property. The concept of comparable yield makes the most sense when applied to a commercial borrower that can otherwise actually borrow at a fixed, comparable rate under general markets and conditions. In that context, the CPDI rules appropriately discourage the significant backloading of interest. But unlike other contingencies, shared appreciation rights are key to the financing. HSAMs make a home purchase possible. Depending on the referenced contingency for a CPDI, commercial parties can use hedging to reduce their exposure, especially in the case of contingencies based on widely published indices and commodity prices. HSAM lenders can face an undiversified, financial risk for extended periods.

Unfortunately, no version of the CPDI regulations provides any specific example of how to apply the CPDI method in the context of a noncommercial transaction such as an HSAM, most likely because home borrowers are cash-basis taxpayers and can only deduct interest when paid. In addition, the last set of CPDI rules did not address or even discuss the treatment of HSAMs in either the context of the REMIC regulations discussed earlier, which allow an HSAM provision to be stripped from a mortgage loan before it is put in a REMIC or in the context of the REIT SAM rules (which require payments based on real estate appreciation to be characterized — and presumably included in income — when made). Either there was no intention to impose the CPDI rules on REMIC-held or REIT-held SAMs or the drafters of the CPDI regulations made significant statute-like changes affecting the REIT and REMIC rules without providing any helpful guidance.

[7] Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1986," JCS-10-87 (May 4, 1987); S. Rep. 99-313, p. 769-782, H. Rep. 99-841, Vol. II, p. 214-221.

[8] T.D. 8674.

[9] Reg. section 1.1275-4.

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For example, under the REMIC regulations discussed earlier, a home mortgage having both a fixed rate (or variable rate) and a shared appreciation component can be made into a qualified REMIC asset by stripping the appreciation component and leaving it in the hands of the depositor (or another third party). If the last set of CPDI rules were intended to apply to an HSAM held by a REMIC, one would anticipate that these REMIC regulations would have been modified or the drafters would have used the preamble to clarify how the new CPDI rules affected a stripped HSAM in the REMIC context. Would the difference between the actual and comparable yield be included in income by the REMIC as the owner of the mortgage loan or in the income of the owner of the stripped appreciation rights? If included in the income of the holder of stripped appreciation rights, would that owner be taxable on just the difference between the comparable yield and the fixed rate and then account for the settlement of the appreciation rights as a regular net positive adjustment or net negative adjustment? Conversely, would the REMIC be compelled to treat an HSAM as a mortgage bearing a fixed rate equal to the comparable yield? In which case, how would the REMIC offset the resulting phantom income (that is, the difference between interest accrued at a comparable yield and interest collected on the loan)? It does not appear that a REMIC could issue a regular interest accruing (but not currently paying) interest at a rate equal to the difference between the actual yield and the comparable yield given (1) the rules against contingencies[10] and (2) a regular interest paying interest based on home appreciation (instead of reflecting contemporaneous changes in interest rates) would not be paying interest at a "qualified floating rate."[11] Or would the REMIC allow the resulting phantom income to increase the excess inclusions of the holder of the residual interest, which would increase the inducement fee demanded by that holder? None of these questions appear to be answered.

[10] Reg. section 1.860G-1(a)(5).

[11] Reg. section 1.1275-5(b)(1) (requiring that variations in the value of a qualified floating rate be reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds).

As another example, if the CPDI rules were intended to apply to a SAM held by a REIT, would they override the statutory scheme of section 856(j) without furnishing some explanation? The CPDI regulations are statutory regulations,[12] but one supposes the drafters of the CPDI rules would at least explain ways or provide rules for navigating the apparent conflict between the REIT code provisions and the CPDI regulations and the complexities resulting from applying the CPDI rules to the REIT SAM rules in section 856(j).

In particular, section 856(j)(1) characterizes shared appreciation payments as gain recognized on the sale of the secured property for purposes of the annual REIT gross income tests under section 856(c). But the section seems to implicitly defer that income until it is earned, providing that "any income derived from a shared appreciation provision shall be treated as gain recognized on the sale of the secured property." But under the CPDI regulations, if the appreciation payment exceeds the interest accrued based on the "comparable yield," the excess is most likely a "net positive adjustment," and characterized as additional interest. Conversely, if the interest accrued based on the comparable yield, exceeds the appreciation payment, the excess is most likely a net negative adjustment. A net negative adjustment first reduces the amount of interest that would otherwise be accounted for the year in which the adjustments arise; the remainder is then treated as an ordinary loss in that year up to the amount of interest income accrued in prior years, and the remainder after that is carried forward and either reduces the amount realized on the disposition of the instrument or is taken as an ordinary loss.

If the CPDI rules were intended to apply to REIT-held HSAMs, one would anticipate that some additional guidance would have been provided unless the intent was to prevent REITs from holding HSAMs. Regarding the characterization of interest accrued at the comparable yield, it would have been helpful had the CPDI regulations explained or affirmed that interest accrued based on the comparable yield still qualified under the REIT gross income tests as

[12] Section 1275(d) (specific reference to "contingent payments").

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interest from a mortgage loan. It would also have been helpful had the regulations confirmed or explained that characterizing net positive adjustments as additional interest was intended to override the statutory treatment of an appreciation payment as gain from the sale of the underlying property. If that override was intended, it would alter the treatment of a SAM secured by property that was held for sale to customers within the meaning of section 1221(a). Treating a net positive adjustment as additional interest instead of gain from property held for sale to customers could help a REIT avoid the prohibited transactions tax, which could otherwise apply under section 856(j)(3) of the REIT SAM rules. If the CPDI rules were not intended to override the REIT SAM assets tests, the question would remain of how to treat a shared appreciation provision regarding a loan secured by inventory. If the appreciation payment resulted in a negative adjustment or positive adjustment, would the difference be treated as a gain or loss from section 1221(a)(1)? In the case of a positive adjustment, presumably (1) the amount of interest income based on the comparable yield in prior years would not be changed, and so the treatment of that income as good REIT income (interest on a mortgage secured by an interest in real property) would not be disturbed, and (2) the amount of income not qualifying under section 856(c) would be reduced by virtue of the netting. In the case of a net negative adjustment, presumably any reduction would be an offset or a deduction, but more importantly, that adjustment would not represent gross income, qualified or not.

Whether one agrees with these technical arguments and the inference that the failure of the CPDI rules to address HSAMs held by REMICs and REITs means the deferral rules were intended to remain in place, and whether one believes these arguments make a case for changing the SAM rules applicable to both HSAMs and commercial SAMs, they at least justify suspending application of the CPDI rules to HSAMs for the present.

It is believed that changing the treatment of HSAMs under the CPDI rules could be accomplished, at least initially, by an administrative notice jointly issued by the IRS and Treasury. That notice could impose sufficient restrictions to limit the benefits of HSAMs used as alternative financing for acquisition of personal residences[13] and might provide as follows:

> (1) In the case of a shared appreciation home mortgage loan described in section (2) of this notice, the interest on that such shared appreciation loan, and the amount of any payment reflecting any appreciation occurring between the time the mortgage loan is originated and the time such payment is due under the terms of such mortgage, may at the election of the lender, be included in income only when paid.
>
> (2) A shared appreciation mortgage loan is described in this section (2) only if all of the following are true:
>
> > (a) the indebtedness is incurred by an individual taxpayer to (i) acquire, construct, or substantially improve a residence that secures such indebtedness, which residence is owned by such taxpayer and used as the taxpayer's principal residence, or (ii) to refinance the unpaid principal balance of a loan described in section (2)(a)(i);
> >
> > (b) the amount of interest currently payable on the loan is less than the amount that would be currently payable if the loan did not require a shared appreciation payment; and
> >
> > (c) the indebtedness does not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return). ■

[13] Relief could also be limited to debts meeting certain additional conditions such as (1) debts secured by, and providing a shared appreciation interest in, homes of four units or less or (2) debts with a minimum, annual coupon set at AFR or a percentage of AFR.

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