Mortgage Modifications Can Result in Significant Tax Savings Due to Forgotten Capitalized Interest

CHARLES R. MARKHAM

Tax practitioners should identity clients with mortgage modifications since 2007 to determine if they have capitalized interest included in the principal of the new loan. This capitalized interest is still deductible but is typically not being reported on Form 1098 to the borrower, and therefore their new mortgages are understating their mortgage interest.

A recent class action lawsuit against a major national bank currently on appeal in the Ninth Circuit[1] claims that issuers of Form 1098 are understating mortgage interest paid by customers who have mortgage modifications. IRS Industry Issue Resolution (IIR) Program[2] filings from the American Bankers Association[3] (ABA) and the Mortgage Bankers Association[4] (MBA) would seem to support the substance of the plaintiffs' claim. These filings ask the IRS to clarify that mortgage lenders should report such payments as interest on Form 1098 going forward.

The legal complaint alleges the amount at issue to be in the "hundreds of millions if not billions" of dollars. While allowing for any legal advocate's potential for hyperbole, the sums involved could indeed be substantial, not only in the aggregate, but as they might apply to individual affected clients, whose tax savings might easily reach the thousands.

Both the lawsuit and the filings arise from mortgage modifications (particular those that occurred under the Home Affordable Refinance Program (HARP) or Home Affordability Modification Program (HAMP)[5] programs) that likely included an interest arrearage capitalized into a new principal loan balance. In such cases, the lender has typically treated this amount as the new principal and "forgotten" its character as unpaid interest on the prior loan.

Meanwhile, taxpayers with prior mortgage modifications have dutifully reported what their Form 1098 has "told" them to report on their taxes as interest paid–not realizing that the figure on the form was likely understating their mortgage interest. Their tax preparers were likely unaware of their

mortgage modifications, let alone the tax implications. Mortgage lenders (whose IIR filings affirm the character of these forgotten interest payments) point out that the IRS never "told" them to report such interest payments on Form 1098.

Regardless of the outcome of this lawsuit and the IIR Program request, their underlying facts offer the alert practitioner an opportunity to realize tax savings for their clients:

1. Many of these affected clients have capitalized interest.
2. The capitalized interest is typically not reported in Form 1098.
3. Capitalized interest is deductible as the principal of the new loan is paid when it can be traced to the portion of the payment that represents interest from the previous mortgage.
4. Therefore, these clients are presented with tax savings opportunities.

Understanding the range of approaches available to claim these savings requires a grasp of the facts, law, and regulations that are behind the current cases.

BACKGROUND ON MORTGAGE MODIFICATIONS

The recent wave of mortgage modifications began in 2007 in response to the downturn in the economy and what has been termed the "subprime meltdown" in the mortgage industry. In a mortgage modification, the borrower and lender renegotiate the terms of a loan to try to work out a loan that is in default–the goal being to avoid foreclosure for the homeowner and to keep a loan in some sort of performing status for the lender.

This wave crested in 2009, when HAMP was rolled out as part of the Obama administration's Making Home Affordable initiative. The FHA, Freddie Mac, and Fannie Mae officially embraced mortgage modification as a means to assist homeowners having difficulty making payments to avoid foreclosure.[6]

As of May 2016, there were nearly 8 million consumers with completed modifications, and more than 1.5 million of them were HAMP modifications. Not surprisingly, 2008 and 2009 were the years with the greatest numbers of modifications, including HAMP modifications, and the numbers have gradually decreased since then.[7] The American Bankers Association estimates that as of October 2015, modifications continued at a rate of 100,000 per quarter.[8]

TAX SAVINGS OPPORTUNITIES FROM MORTGAGE MODIFICATIONS

A mortgage modification is any agreement by a lender to change any of the terms of the mortgage on a subject property. The terms of the existing note are amended by agreement, in contrast to a refinance, in which a new note replaces the old. The new loan balance then typically has a new rate and term. In the most favorable situation, the new loan includes a permanent (or at least a temporary) reduction in interest rate.

Not all mortgage modifications are created equal. A modification that simply lowers an interest rate is not a concern. Note that tax savings opportunities arise when a mortgage interest arrearage is capitalized into the new loan principal balance. Most modifications during the time frame considered did involve arrearages. In such cases, the documentation (when it can be located) will be *unequivocal* on this point.

See Exhibit 1, for a typical example of the paperwork for an actual HAMP mortgage modification, and note that it shows the interest capitalized in the new principal. While in this case, the interest capitalized was between three and four thousand dollars, it represented over a thousand dollars in tax savings to the grateful client in question.

The author is aware of perhaps two to three clients per year within his 400-client practice that had mortgage modifications over the past decade. However, other than making passing note of this fact, the mortgage modification seemed to have very little impact on the preparation of their taxes.

The taxpayers did *not* have a HUD-1 document from the closing, since a modification is not a refinance. They simply had a 1098 and a few war stories for how harrowing the whole process had been. (Note sometimes they had two 1098s, sometimes they had only one.) However, tax professionals with affected clients are likely missing an opportunity by not following up on the tax savings a mortgage modification may present.

CAPITALIZING PAST DUE INTEREST, CONVERTING IT TO NEW PRINCIPAL, *AND THEN WHAT?*

Here is a simple situation for an example. Suppose a client had a $200,000 mortgage at 8.5%, and in 2013 and 2014, she had fallen behind and is now $25,000 (18 months) in arrears. In 2014, she successfully negotiates a modification. The newly modified mortgage is at 5% for a new balance of $225,000 and a new term of 25 years. Even with the increased balance, her new payment goes down by more than $300 a month.

The client's tax adviser was not particularly aware of the matter. In 2013, the client's 1098 showed little interest because she had stopped paying her mortgage. In 2014, her 1098 now reflects the lowered interest and payments.

The client asks her tax adviser if she can deduct the past-due mortgage payments that were rolled into the balance. He explains to her that she is a cash-basis taxpayer and cannot deduct what she has not paid. With that, the $25,000 or so in capitalized interest is pretty much forgotten.

Should it have been, however? Was the tax adviser's answer too quick?

A counter argument for why the capitalized interest *should* be de-

CHARLES R. MARKHAM is the principal of Markham & Company LLC in Norwell, Massachusetts.
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ductible might go like this: Suppose that, instead of modifying the mortgage, the client had simply refinanced and borrowed a new $225,000 mortgage to pay off the arrearage. The outcome of this hypothetical situation would be exactly the same as this current situation. The client would owe $225,000 in debt with no personal cash outlay. In this hypothetical instance, she would have been issued a 1098 that would have included the recently $25,000 past due payment since that mortgage was now paid in full.

The Tax Court recently decided this very issue in *Copeland*, TCM 2014-226. In *Copeland*, the taxpayer had a mortgage modification with capitalized interest, and the Tax Court ruled that there was no wholesale mortgage interest deduction due to the modification.[9]

EXHIBIT 1

HAMP Mortgage Modification

This Document Prepared By:

____

When Recorded Mail To:

____

Source of Title: ________________

Tax/Parcel No. _______

Original Principal Amount: $__________ Freddie Mac Loan No.:
Unpaid Principal Amount: $___________ Loan No: (scan barcode)
New Principal Amount $___________
New Money (Cap): $_________

LOAN MODIFICATION AGREEMENT (MORTGAGE)
(Fixed Rate)

THIS LOAN MODIFICATION AGREEMENT ("Agreement"), made on the ____ day of 20__ (the"Modification Effective Date"), by and between ___________ AND ___________, HUSBAND AND WIFE AS TENANTS BY THE ENTIRETY (the "Borrower(s)") whose address is ____________________ and __________ BANK, N.A. ("Lender'") whose address is ________________________________ (the "Lender (Mortgagee) together with the Borrower(s), the "Parties'"), modifies and amends certain terms of Borrower's indebtedness evidenced by (l) the Note (the "Note'") to Lender dated ___________, in the original principal sum of U.S. $__________ and secured by (2) the Mortgage, Deed of Trust, or Security Deed (the "Security Instrument") and Rider(s), if any, the Note bearing the same date as and recorded on ____________ in BOOK ______ PAGE ____, of the OFFICIAL Records of ___________ COUNTY, _____________. The Security Instrument covers the real and personal property described in the Security Instrument and defined as the "Property," located at:

____
[Property Address]

The real property described being set fotth as follows:

SEE EXHIBIT "A" ATTACHED HERETO AND MADE A PART HEREOF:
WITNESSETH

WHEREAS, Borrower has requested and Lender has agreed. subject to the following terms and conditions, to a loan modification as follows:

NOW THEREFORE, in consideration of the covenants hereinafter set fmih and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged by the Parties, it is agreed as follows (notwithstanding anything to the contrary in the Note and Security Instrument date ____________.

IRS PROVIDES CLEAR GUIDANCE ON CAPITALIZED INTEREST: STUDENT LOANS

While *Copeland* provides clear guidance on how *not* to treat capitalized interest, in the instance of student loans, the IRS provides guidance on how capitalized interest *should* be handled. Section 221 allows deduction of student loan interest as an adjustment to income. The section itself allows "interest" with no references to capitalized interest. However, the Department of the Treasury's proposed rulemaking[10] in January 1999, interpreting Section 221, included a definition of interest that specifically included capitalized interest.

Student loans are an interesting loan category in that most have an initial period when there is no repayment but interest accrues. The interest accrues until the "loan capitalization date," a date close to the graduation date when the loan goes into repayment. At this moment, the interest accruing while the student was in school is capitalized and added to principal and becomes part of the new balance of the loan. Thus, when students are paying off student loans after graduation, in essence they are paying three things: (1) current interest on the loan, which is deductible student loan interest,[11] (2) repayment of the initial loan principal, which is not deductible, and (3) prior interest accrued during their school years, which has now capitalized. The Treasury had to address whether or not this third component was deductible interest. At the time, many lenders had converted it to principal on their books and were in fact not treating it as interest. This is of course analogous to the lending in-

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1 *Smith vs. Bank of America, NA* (Case 2:14-cv-06668-DSF-PLA)

2 www.irs.gov/Businesses/2015-Issue-Selected-for-the-Program-12-29-15.

3 October 16, 2015 Letter to IRS from ABA Application for Industry Issue Resolution Program per Rev. Proc 2003-36.

4 September 15, 2015 Industry Issue Request Program submission by the Mortgage Bank Association to the IRS under Rev. Proc. 2003-36.

5 The federal government created the Home Affordable Modification Program (HAMP) and the Home Affordable Refinance Program (HARP) as part of a broader effort to help homeowners avoid foreclosure and stabilize the nation's housing market.

6 For example, Freddie Mac and Fannie Mae have the HARP program, FHA has the "Short Refinance Program (See portal.hud.gov/hudportal/HUD?src=/hud-programs/fhahamp).

7 www.hopenow.com/industry-data/HopeNow_Full_Report_Updated_May.pdf.

8 October 16, 2015 Letter to IRS from ABA Application for Industry Issue Resolution Program per Rev. Proc 2003-36.

9 See also *Heyman*, 70 TC 482 (1978) (construction loan converted to permanent interest was not deductible).

10 REG-116826-97, 1999-1 CB 701, 64 Fed. Reg. 3257.

11 Student interest is reportable on Form 1098-E and potentially deductible given AGI and certain other items.

EXHIBIT 1, CONTINUED

HAMP Mortgage Modification

L The modified principal balance of my Note will include all amounts and arrearages that will be past due as of the Modification Effective Date (including unpaid and deferred interest fees, escrow advances and other costs, but excluding unpaid late charges, collectively, "Unpaid Amounts") less any amounts paid to the Lender but not previously credited to the Modified Loan. The new principal balance of my note will be $________ (the "New Principal Balance"). Borrower understands that by agreeing to add the Unpaid Amounts to the outstanding principal balance, the added Unpaid Amounts accrue interest based on the interest rate in effect under this Agreement. Borrower also understands that this means interest will now accrue on the unpaid interest that is added to the outstanding principal balance, which would not happen without this Agreement.

2. Interest at the rate of ______% will begin to accrue on the New Principal Balance as of ____________ and the first new monthly payment on the New Principal Balance will be due on ____________. Borrower agrees to make monthly payments for the Modified Loan as outlined in the payment schedule below:

Months	Interest Rate	Interest Rate Change Date	Monthly Principal and Intcrcst Payment	Monthly Escrow Paymcnt Amount*	Total Monthly Payment*	Pavment Begins On	Number of Monthly Payments
1-____	______%	________	$_______	$_______ Adjusts annually after year 1	S_______	_________	_____

*The escrow payments may be adjusted periodically in accordance with applicable law and therefore my total monthly payment may change accordingly.

The above terms in this Section 2 shall supersede any provisions to the contrary in the Note and Security Instrument, including but not limited to provisions for an adjustable, step, or simple interest rate.

Borrower understands that, if I have a pay option adjustable rate mortgage loan, upon modification, the minimum monthly payment option, the interest-only, or any other payment options will no longer be offered and that the monthly payments described in the above payment schedule for my Modified Loan will be the minimum payment that will be due each month for the remaining term of the Loan. My Modified Loan will not have a negative amortization feature that would allow me to pay less than the interest due, resulting in any unpaid interest being added to the outstanding principal balance.

3. EXTENSION. This Agreement hereby modifies the following terms of the Note and Security Instrument described herein above as follows:

a. The Current contractual due date has been extended from ______________ to ________________The first modified contractual due date is on ________________

dustry's prevailing current practice with mortgage modifications.

In May 2004, the IRS, issuing final regulations on student loan interest, responded to industry feedback questioning the proposed treatment of capitalized interest as interest:

> Several commentators discussed the treatment of capitalized interest, loan origination fees, late fees, and certain insurance fees. Courts have defined the term "interest," for income tax purposes, as compensation paid for the use or forbearance of money. See., e.g. *Deputy v. Du Pont*, 308 U.S. 488 (1940). Consistent with this definition, the *final regulations provide that capitalized interest is deductible as qualified education loan interest*.[12]

The IRS held firm. Many lenders had not been including capitalized interest in the definition of interest, so the final regulations included a transition rule: lenders were given a date in 2004 to convert their systems to comply. Thus, in the student loan environment where capitalized interest and its payment is commonplace, the Service has spoken clearly and unequivocally on its deductibility. Similarly, the education loan interest reporting regulations (Reg. 1.6050S-3(b)(1)) explicitly include capitalized interest in the definition of interest to be reported. Therefore, when the capitalized interest is ultimately paid, such payment is included in Form 1098-E.[13]

ADDITIONAL GUIDANCE ON CAPITALIZED INTEREST

While the student loans example addresses the IRS's position on capitalized interest administratively, the issue of capitalized interest on other types of loans (typically mortgages) has also been addressed in other contexts, notably in a variety of court cases.

Capitalized interest is addressed in *Smoker*, TCM 2013-56. The Tax Court opines:

> [W]hether interest is charged by way of an original issue discount (OID) (i.e., interest withheld from the loan proceeds) or as capitalized interest (i.e., periodic interest added to the loan's principal), the economic reality is the same: the borrower is able to postpone paying the interest due to sometime in the future, either over the life of the loan or as part of a balloon payment upon maturity.

In *Motel Corp.*, 54 TC 1433 (1970), the court focuses even more squarely on this point:

> In reaching this conclusion, we start from two basic premises. The first is that interest is compensation for the use of money. *Deputy* v. *DuPont*, 308 U.S. 488 (1940). The second is the fundamental proposition of tax law that in determining the tax treatment of a transaction, substance governs form. *Gregory* v. *Helvering*, 293 U.S. 465 (1935). Viewed substantively, we can perceive no reason why defaulted interest should be transformed into principal for purposes of tax law. Such interest, no matter when paid, is clearly compensation for the use of money, and its character as such does not change merely because it is not timely paid. The fact that a payment is not called "interest" is not controlling for tax purposes if, in substance, it is such. See *Wilshire Holding Corporation* v. *Commissioner*, 262 F.2d 51 (C.A. 9, 1958), reversing a Memorandum Opinion of this Court.
>
> Having concluded that defaulted interest does not become principal for tax purposes, we must next consider when such interest is treated as paid. Partial payments on a note are generally treated as first applying to interest and then to reduce principal. *Estate of Daniel Buckley*, 37 T.C. 664 (1962); *Estate of Paul M. Bowen*, 2 T.C. 1

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12 www.irs.gov/irb/2004-23_IRB/ar06.html, TD 9125, 5/7/04 (emphasis added).

13 Form 1098-E even has a check box on it to indicate when capitalized interest is being included in the interest box. One would assume that refinancing a student loan would cause a large amount of capitalized interest to be paid in a given year. But since student loan interest is both subject to AGI limitations as well as an absolute annual cap of $2500, most practitioners have never paid too much attention to any sudden increases in student loan interest reported annually.

(1943); Theodore R. Plunkett, 41 B.T.A. 700 (1940), affd. 118 F.2d 644 (C.A. 1, 1941). This rule was expressly included in the Barrett note. Since each payment made in 1962 was less than the interest accrued and unpaid to the date of the payment, the entire amount of the payments made in that year were allocable to the payment of interest and taxable as such.

In Rev. Rul. 70-647, 1970-2 CB 38, the IRS in a different context provides guidance regarding the deductions of interest on a new loan that replaced an old loan from the same lender. The new loan included as principal the unpaid interest on the old loan–in effect a loan modification although the term was not in use at the time. The IRS noted that "the lender's records now indicate only an outstanding loan of [X] dollar new principal without differentiation between interest on the old loan and principal." The Service then ruled that "it is incumbent on the individual to keep his own record of loans, interest and payments."

SMITH. V. BANK OF AMERICA, NA

In the class action lawsuit, *Smith vs. Bank of America, NA*, which began this article, Lora Smith and Cynthia Himple, individually, and on behalf of the class of all others similarly situated (Complainants) argued that Bank of America should have included the amortized interest in the Forms 1098 for its customers with mortgage modifications. In its motion to dismiss, Bank of America argued that nothing was keeping the complainants' class of taxpayers from including the additional mortgage interest in their taxes and, in addition, that it was not supposed to have included this interest on Forms 1098 or certainly was never instructed to prepare the form in such a fashion.

In its 9/15/15 letter to the IRS in which it requested an Industry Issue Resolution under Rev. Proc. 2003-36, 2003-1 CB 859, the Mortgage Bankers Association states:

> As a result, institutions in the mortgage lending and servicing industry (Reporting Institutions) must determine whether, when, and how to report the Capitalized Amounts on Form 1098. *It seems likely that many Reporting Institutions have treated modified mortgages as new loans for information reporting purposes*–consistent with the substantive tax treatment of such instruments–*and have treated the ultimate repayment of Capitalized Amounts by borrowers as payment of principal*, as dictated by the terms of the modified instrument.[14]

In short, the Mortgage Bankers Association is saying that most bankers treated the capitalized interest as principal and did not include it in the Form 1098. The interest–*as* interest–has been lost.

EXHIBIT 1, CONTINUED

HAMP Mortgage Modification

b. The maturity date has been extended from _______________ (month/year) to _________________.
c. The amount of interest to be included (capitalized) will be U.S. $___________.
d. The amount of the Escrow Advance to be capitalized will be U.S. $________.
e. The amount of Recoverable Expenses to be capitalized will be U.S. $_____. Recoverable Expenses may include, but are not limited to: Title, Attorney fees/costs, BPO/ Appraisal, and/or Property Preservation/Property Inspections.
f. I agree to pay in full any amounts still owed under the Note and Security lnstrument by the earliest of' (i) the date l sell or transfer an interest in the property, (ii) the date l pay the entire New Principal Balance, or (iii) the maturity date.
g. Borrower agrees that certain amounts owed will not be capitalized, waived, or addressed as part of this Agreement, and will remain owed until paid. These amounts owed are referenced in the Cover Letter to this Agreement, which is incorporated herein, and are to be paid with the return of this executed Agreement. If these amounts owed are not paid with the return of this executed Agreement, then Lender may deem this Agreement void.

4. NOTE AND SECURITY INSTRUMENT. Nothing in this Agreement shall be understood or construed to be a satisfaction or release, in whole or in part of the Borrower's obligations under the Note or Security Instrument. Further, except as otherwise specifically provided in this Agreement, the Note and Security Instrument will remain unchanged, and Borrower and Lender will be bound by and shall comply with all of the terms and provisions thereof, as amended by this Agreement.

5. The undersigned Borrower(s) acknowledge receipt and acceptance of the Loan Modification Settlement Statement. Borrower(s) agree with the information disclosed in and understand that 1/we am/are responsible for payment of any outstanding balances outlined in the Loan Modification Settlement Statement.

6. The undersigned Borrower(s) acknowledge receipt and acceptance of the Borrower Acknowledgements, Agreements, and Disclosures Document (BAAD).

7. If included, the undersigned Borrower(s) acknowledge receipt and acceptance of the Truth in Lending statement.

8. If included, the undersigned Borrower(s) acknowledge receipt and acceptance of the 1-4 Family Modification Agreement Rider Assignment of Rents.

9. If included, the undersigned Borrower(s) acknowledge receipt and acceptance of the Notice of Special Flood Hazard disclosure.

10. This Agreement is conditioned upon the receipt of the 1-4 Family Modification Agreement Rider Assignment of Rents, if included, specified in the attached cover letter, which is incorporated herein by reference.

CHARTING THE UNCHARTED: ALLOCATING PAYMENTS TO INTEREST ABSENT FORM 1098

The next question might be how should loan payments be allocated to recover the interest. The answer appears to lie back with the student loan capitalized interest discussion above. The IRS was confronted with the exact situation, and the education loan interest regulations (Reg. 1.221-1(f)(3)) state:

> (3) *Allocation of payments.* In general, these rules treat a payment first as a payment of interest to the extent of the interest that has accrued and remains unpaid as of the date the payment is due, and second as a payment of principal. The characterization of a payment as either interest or principal under these rules applies *regardless of how the parties label the payment (either as in-*

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[14] September 15, 2015 Industry Issue Resolution Program submission by the Mortgage Bank Association to the IRS under Rev. Proc. 2003-36 (emphasis added).

EXHIBIT 2

Mortgage Modification in Which a Portion of The Past-Due Principal and the Capitalized Interest Was Simply Allowed to Become a Non-Interest Bearing Second "Balloon" Mortgage

__________, 20__

Congratulations on successfully completing your Making Home Affordable loan modification. Enclosed is a copy of your signed permanent loan modification agreement Please retain this copy with your mortgage records.
If you have questions about this letter or the enclosed agreement, please call us at ____________, Monday through Thursday from 9 a.m.- 11 p.m. and Friday from 9 a.m.- 9 p.m. Eastern.

Home Loan Team
____

_______________ is required by law to inform you that this communication is from a debt collector.

SUMMARY

FORMER PRINCIPAL BALANCE. Your former unpaid principal balance, before the loan modification is stated below. This balance does not include, if applicable, any past-due interest, any servicing expenses that we paid to third parties, and any real estate taxes and insurance that we paid for you.

TERMS OF THE MODIFIED MORTGAGE

Former principal balance:	$____________
Principal deferment (moved to Partial Claim):	$____________
Past-due payments included in Partial Claim (15 months):	$____________
Delinquent escrow included in Partial Claim:	$____________
New modified principal balance:	$____________
New fixed interest rate:	____%
Effective date of the new fixed interest rate:	_________, 20__
New monthly payment of Principal and Interest (P&I) only:	$____________
Monthly payment of P&I plus tax and insurance escrow:	$____________
New maturity date:	_________, 20__

REPRESENTATIONS. Please carefully read the enclosed Home Affordable Modification Agreement. Make sure that you understand it and that the statements set forth in the "My Representations" section are true and accurate. If you have any questions, please call us at ____________.

NEW MORTGAGE PAYMENT. Your new modified monthly mortgage payment is shown in the above. This payment will change if your escrow payment changes. Your monthly payments will be due the same day each month, starting on __________, 20__.

TERM EXTENSION. To make your mortgage payments more affordable, the loan modification will extend the length of your loan to ____ months from _________, 20__. Your new maturity date is shown above.

terest or principal). Accordingly, the taxpayer may deduct the portion of a payment labeled as principal that these rules treat as a payment of interest on the loan, including any portion attributable to capitalized interest or loan origination fees.

(4) *Examples.* The following examples illustrate the rules of this paragraph (f). In the examples, assume that the institution the student attends is an eligible educational institution, the loan is a qualified education loan, the student is legally obligated to make interest payments under the terms of the loan, and any other applicable requirements, if not otherwise specified, are fulfilled. The examples are as follows…

Example 1. *Capitalized interest.* Interest on Student K's loan accrues while Student K is in school, but Student K is not required to make any payments on the loan until six months after he graduates or otherwise leaves school. At that time, the lender capitalizes all accrued but unpaid interest and adds it to the outstanding principal amount of the loan. Thereafter, Student K is required to make monthly payments of interest and principal on the loan. The interest payable on the loan, including the capitalized interest, is original issue discount. See section 1273 and the regulations thereunder. Therefore, in determining the total amount of interest paid on the loan each taxable year, Student K may deduct any payments that § 1.1275-2(a) treats as payments of interest, including any principal payments that are treated as payments of capitalized interest.[15]

The rule that a payment is first applied to current interest and then, when applied to principal, is first applied to capitalized interest would thus appear to be totally appropriate under Reg. 1.446-2(e). Applying a payment first to capitalized interest is simply an extension of the "every payment is first applied to interest before it is applied to principal" rule that pervades all loans, as confirmed by the Tax Court in *Motel Corp.*, citing plural precedents.

Despite this completely allowable method of treating principal payments initially as interest, it should be emphasized that "the taxpayer *may* deduct the portion labeled as principal that these rules…" Since it does not say "shall," the taxpayer does not have to. Thus, a tax professional may wish to consider any reasonable method to amortize the capitalized interest embodied in the principal payments.

PRACTICAL CONSIDERATIONS AND APPROACHES

The amortization of a new loan should be prepared on a spreadsheet with a column added for the capitalized interest. As the new principal is paid (which will be small in the beginning of the new loan), it would instead be replaced with non-1098 mortgage interest from the capitalized interest; its use would then be tracked until the capitalized interest is gone. This is clearly the correct way to do this when interest is being capitalized and paid in the new loan.

The tax professional should also consider the use of straight-line amortization over the life of the new loan term.[16] This allows tax professionals

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15 Emphasis added.

16 Amortizing the accrued interest in a straight line over the life of the new mortgage is an analytical and administrative simplicity that both the IRS and the courts would likely look favorably on. To compare, there is no analytical rationale for the current convention of amortizing prepaid points linearly over the life of loan. In fact, a point is pre-paid interest and, if anything, should be retired in proportion to mortgage interest paid in a given year over total mortgage to be paid over the life of a loan. Such a calculation, however, would be unreasonably complicated and thus amortizing linearly over the life of the mortgage has been blessed by all—the IRS, the courts, and Congress. There would be little reason to believe a similar outcome would not result here.

to use the feature in their software that tracks amortization of points over a number of years. While this provides a practical means of tracking this deduction over time, note that amortizing capitalized interest is different from amortizing a prepaid point.

EXHIBIT 2, CONTINUED

Mortgage Modification in Which a Portion of The Past-Due Principal and the Capitalized Interest Was Simply Allowed to Become a Non-Interest Bearing Second "Balloon" Mortgage

NO UNAPPLIED FUNDS. At the end of your trial period, if there were any funds that we had not yet applied to your loan, we will apply those funds as part of the modification.

PARTIAL CLAIM. To bring your loan current and to make your mortgage payments more affordable, the FHA will advance funds ("Partial Claim Amount") on your behalf to the owner of your first mortgage. In return, so the FHA can eventually recover that amount, you must sign a zero-interest subordinate promissory note and subordinate mortgage ("Partial Claim Mortgage") by which you promise to pay the Partial Claim Amount to the Secretary of Housing and Urban Development ("HUD") on the earlier of:

1. ___________ , 20__;
2. When you otherwise pay the modified Mortgage in full;
3. When the Partial Claim Mortgage and/or modified first mortgage has been accelerated;
4. When the Partial Claim Mortgage and/or modified Mortgage is no longer insured by HUD, or
5. When you do not occupy the property as your principal residence.

PARTIAL CLAIM AMOUNT. The Partial Claim Amount of $___________ includes the following:

1. Arrearages (past-due amounts) of $__________ (which cannot exceed 30% of the unpaid principal balance):

a. Past-due principal:	$____________
b. Past-due interest:	$____________
c. Past due escrow:	$____________
d. Past-due FHA mortgage insurance premium:	$____________

2. Escrow Shortage:	$____________
3. Principal (subtracted from the Mortgage):	$____________
4. Foreclosure costs:	$_____________
5. Bankruptcy costs:	$_____________

If you want to accept the terms of this proposed loan modification, each borrower must sign the Loan Modification Agreement, the Partial Claim documents, and (if any) other enclosed documents. Where indicated, your signatures must be notarized by ___________, 20__. You must return all the required documents to:

____
____
____
____

If you have any questions, please call _____________.

WHAT HAPPENS UPON SALE OR REFINANCE OF THE MODIFIED LOAN?

A completely different type of mortgage modification that has not been discussed is highlighted in Exhibit 2. In this example, a portion of the past-due principal and the capitalized interest was simply allowed to become a non-interest bearing second "balloon" mortgage. This second mortgage just "sits there" until the property is sold, refinanced or foreclosed upon. Once again, buried in the "principal" of the second mortgage is a reasonably large[17] amount of capitalized interest that becomes a current tax deduction when that second mortgage is paid off, assuming its character as interest is not forgotten.

Thus, in this situation as well as in the regular situation in which the capitalized interest is amortized, the real "bang for the buck" is not in the annual amortizing, but in the ensuing write off of the balance of the deduction when the modified loan is paid off in full via the sale of the home or in refinance of the loan[18].

The Tax Court stated in *Smoker* that the taxpayer may "postpone paying the interest due to sometime in the future, either over the life of the loan or *as part of a balloon payment upon maturity*,"[19] and claim the interest deduction then. Therefore, the real deduction is going to come when previously modified clients pay off that mortgage either via refinance (with a new bank) or via a sale.

This would mean that a rather large amount of interest is going to be deducted on Schedule A or E, without a corresponding 1098. In such instances, the tax professional taking this position on behalf of a client is well advised only to do so when he or she has in hand full documentation of the mortgage modification and can clearly show the amount of capitalized interest included in the recently retired loan.

FINAL SCENARIO: THE MODIFIED LOAN IS FORECLOSED, ABANDONED, OR SOLD SHORT.

According to industry sources,[20] a substantial portion of modified loans eventually wind up again in default, making modification simply a step along the way to the inevitable foreclosure. Therefore tax professionals may find themselves staring at a Form1099-C, having to compute taxable income due to cancellation of indebtedness from the modified mortgage. Of course, many times the Form 1099-C amount is completely nontaxable due to insolvency or because the principal residence exclusion still applies; however, sometimes a tax cal-

NOTES

17 Note that in the example provided in the illustration the capitalized interest is more than $19,000—quite a substantial amount of capitalized interest to uncover.

18 Note that the refinance must be with a completely different bank and cannot be with the current lender.

19 Emphasis added.

20 mortgagebankers.org/files/Conferences/2012/RMQA12/RMQA12AhmedFazil.pdf.

EXHIBIT 3

STEP 1. Include the topic in annual newsletter and/or add question in annual client questionnaire "Have you modified a mortgage since 2007-8? A mortgage modification is defined as one in which the loan remained with the same bank, past due interest was added to the balance, and the rate and terms were modified."

STEP 2. A handful of clients may say "yes." You would then need to request the full mortgage modification documentation. Many will be "false positives" and you will really be able only to continue with the ones for whom you can positively identify a document that specifies the capitalized interest. This is critical to have should you one day be at loggerheads with the IRS over this matter.

STEP 3. By carefully reviewing the new amortization schedule, you can likely prove to yourself that the capitalized interest is being treated as principal (which is incorrect). You now must decide what to recommend doing with this completely buried capitalized interest that has been identified.

STEP 4. You can file amended returns, start to amortize, or simply wait until the loan is refinanced or sold and deduct it in full at that time. All of these have pros and cons. The IRS always wants mortgage interest to match what is included on Form 1098. Perhaps the IRS Industry Issue Resolution program will come to the rescue, but by then the statute of limitations may have expired.

culation must be made, for example, because of rental property or non-acquisition indebtedness.

If the Form 1099-C is for a modified mortgage, and the debt cancellation included some debt that can be traced back to capitalized interest, the tax professional should consider whether Section108(e)(2) applies. Section108(e)(2) states that debt cancellation is not taxable to the extent that payment of the liability would have given rise to a deduction. Since payment of capitalized interest very frequently would have given rise to a deduction (think of both Schedule A or Schedule E), to the extent that capitalized interest is included in the debt cancellation, the alert tax professional can save his or her client from paying taxes on at least that portion of taxable debt cancellation.

NEXT STEPS FOR THE TAX PROFESSIONAL

While these considerations apply only to a handful of clients, for the few that it does, it could represent significant tax savings. A tax professional should simply add a question on the client questionnaire or organizer to identify those clients with mortgage modifications that occurred since 2007. Once identified, these clients will have to provide paperwork received at the "closing" of the modification. Amendments or taking these deductions should be pursued only when the client can fully document the capitalized interest amounts. This article includes two examples of mortgage modification documents, both of which clearly show the amount of interest capitalized.

Once the tax professional has identified clients who have capitalized interest that is not being reported on Form 1098, the question is what to do. In many cases, the path of least resistance is to start to amortize the interest ratably over the life of the mortgage.[21] Based on the foregoing discussion, treating the payments as "interest first" is clearly correct. Amortizing the interest over the life of the mortgage with a "balloon amortization" when the loan is refinanced or paid off should also be allowed as a valid treatment. One must be careful to use the appropriate lines on Schedule A so as not to report on the lines on which the IRS wants to match up mortgage interest with a Form 1098. (See Exhibit 3 for steps that tax practitioners interested in client mortgage modification deductions can take.)

NOTES

21 In some cases, this meant that the client would simply lose several preceding years of interest that went unclaimed, but there still was a large amount of unclaimed, unamortized interest left.