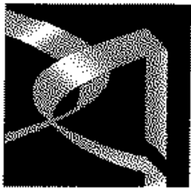

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November 4, 2015

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***Via Federal Express***

**INTERNAL REVENUE SERVICE**
Office of Prefiling and Technical Services
Large and Mid-Size Business Division LM:PFT
Mint Building 3rd Floor M3-420
1111 Constitution Avenue NW
Washington, DC 20224

**Re:** ***Revenue Procedure 2003-36 – Interested Party Response To Application For Industry Issue Program – Information Reporting For Accrued But Unpaid Interest With Respect To Loan Modifications Made By the American Bankers Association On October 16, 2015***

Dear Sir or Madam:

We are writing because the Internal Revenue Service ("IRS" or "the Service") encourages interested parties to submit information that will assist the Service and the United States Department of the Treasury in reaching appropriate resolutions of issues presented to the Service under Rev. Proc. 2003-36.

Specifically, we are "interested" in the October 15, 2015 submission of the American Bankers Association ("ABA") relating to the issue, as phrased in its letter, of: "whether interest that is due to the lender, but not paid, becomes part of the principal of a modified mortgage." The reason we are "interested" is because we are counsel for the plaintiffs in the case of *Lora Smith, et al. v. Bank of America, N.A.* (Ninth Circuit Court of Appeals No. 15-55674) (referenced in footnote 3 of the ABA's letter) which involves precisely this issue. We are also "interested" because we are counsel to plaintiffs in the cases of *Pemberton, et al. v. Nationstar Mortgage, LLC* (S.D.CA Case No.: 14CV1024 BAS WVG) ("Pemberton"); *Rovai v. Select Portfolio Servicing, Inc.* (S.D.CA Case No.: 14-CV-1738-BAS-WVG) ("Rovai"); *Strugala v. Flagstar Banks, FSB* (N.D.CA Case No. 5:13-cv-05927-EJD); and *Camberis v. Ocwen Loan Servicing, Inc.*, (N.D.CA Case No.

3:14-CV-02970-EMC) ("Camberis") which raise a related issue of whether interest recipients must report on Form 1098 payments of interest (on unmodified loans) that borrowers had deferred paying in earlier years of their mortgage. (The ABA's letter also references two of these cases in the same footnote). [1]

**1. Summary Of Our Position**

The answer to the question posed by the ABA can be found in the unambiguous language of 26 U.S.C. Section 6050H; the language of the underlying mortgage notes; the authorities summarized below; and in common sense. All point inexorably to the conclusions: (1) that the payment of previously deferred mortgage interest must be reported on Form 1098 by the recipient of that interest in the year of actual payment and (2) that an intervening loan modification does nothing to change this.

We believe that the authorities are so clear on these points that there is no need for the IRS to issue any "guidance." In fact, we believe that the only reason the ABA is seeking "guidance" is that some of its members (likely the ones who we have sued) are seeking to have the IRS unwittingly help them avoid exposure in litigations like ours for their having improperly reported the mortgage interest payments of millions of Americans. They are hoping to be able to create their own precedent so they can argue in Court that the IRS's issuance of some sort of "prospective" "guidance" proves that an ambiguity existed in the law such that their under-reporting of interest was "reasonable."

The Service should not allow itself to be so ill-used. In like instances, the Service chooses not to issue opinions where the subject matter is already the subject of litigation. See, e.g., Rev. Proc. 2015–1 section 6.01 and Rev. Proc. 2015–9 section 4.04. The same rationale applies here. The Service should not facilitate the path for the banks we have sued to escape liability for having cost tax-payers literally billions of dollars in tax deductions that even the ABA concedes they were absolutely legally entitled to take. As the ABA letter puts it: "Considerations should be given to borrowers who may need to make changes in the interest deductions taken in previously filed returns." (It should be noted that in many cases, because of the passage of the 3-year statute of limitations (26

[1] We welcome this opportunity as "interested" parties to provide our input to the Service since we have already sought to obtain the Service's position on the reportability of capitalized interest on Forms 1098 by our prior correspondence to Blaise Dusenberry of the Procedure & Administration section of the Service.

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U.S.C. 6511), it is too late for many borrowers to seek relief by way of amended tax returns).

While the ABA wants the Service to assume that there is an ambiguity in the law because some of its banks are reporting on Forms 1098 payments of deferred interest while others are not, its letter cites absolutely no law and makes no legal argument to support this conclusion. The mere fact that some banks are reporting interest in a manner that is contrary to well-established law does not mean that there is an ambiguity in the reporting requirements. It just means that those banks are doing it wrong.

The real truth is that some ABA member banks (like Bank of America) chose expediency over compliance. Because tracking deferred interest is costly, Bank of America simply stopped doing it in 2009 (with no notice to borrowers).[2] Another good example of a bank doing what it wants rather than adhering to law is Flagstar Bank, FSB ("Flagstar"). Until 2010, Flagstar had been reporting on Forms 1098 not only the amounts of interest its borrowers were paying, but also the amounts they were accruing. When Flagstar realized on its own in 2010 that this was wrong, it unilaterally determined (again with no notice to its borrowers or to the IRS) that rather than issuing corrected Forms 1098 to its borrowers, it was unilaterally going to try to "make up" for its error by intentionally under-reporting its borrowers interest payments in tax-years 2011 forward (up to the amounts it had over-reported in the tax-years prior to 2011).[3] These examples demonstrate that it is hubris, and not any legal ambiguity, that is the root of the banks' wrongful reporting.[4]

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[2] The ABA letter makes it clear that it is more complicated/costly to track payments of previously deferred interest when it says: In normal circumstances, [where there is no deferral, 1098] reporting is routine and systems have been developed to capture and report this information. Reporting becomes less routine when there is a modification of an existing loan." *Id.* at 2. The banks clearly have not wanted to incur the cost of developing "systems" to track deferred interest.

[3] Flagstar also did not tell the IRS what it was doing and its self-help "solution" is completely insupportable from a tax law perspective; it is bedrock tax law that each tax year is separate and distinct from another. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363 (1931). Indeed, the Ninth Circuit has specifically held that it is not proper to try to correct mistakes made in one tax year by trying to make up for them in another tax year. *CIR v. Laguna Land & Water Co.*, 118 F.2d 112, 117 (9th Cir. 1941) ("None of these cases holds that an improper deduction from the gross receipts from a specific piece of property sold in one year may be corrected by refusing a deduction upon the sale of a different piece of property in a different year.") See also *In re Raney*, 132 B.R. 63, 66 (Bkrtcy.D.Wyo. 1991) (debtor could not offset against later tax year overpayments made in earlier years).

[4] Nor is the fact that two federal judges (in the *Strugala, Pemberton* and *Rovai* cases) have chosen to invoke the doctrine of primary jurisdiction to seek the Service's view on the reportability of deferred interest evidence of any

As will be shown, the law is clear that borrower payments of capitalized mortgage interest are properly reportable on Form 1098 by the recipient of that interest in the year of payment and that loan modifications do not present any exception to this rule. Thus, we would request that if the Service determines to issue guidance, as the ABA has requested, it should make clear in doing so that it is simply restating existing law.

We will now explain our legal position.

**2. The Capitalization Of Mortgage Interest And Adding It To Principal Does Not Change Its Character As Mortgage Interest**

Accuracy lies at the core of section 6050H. Passed as part of the Deficit Reduction Act of 1984, section 6050H is all about getting the mortgage interest deduction right: "Information reporting by third parties is a vital function in our system of funding the government largely through taxpayers' voluntary compliance with our tax laws. Information returns are vehicles that can deliver data to the Internal Revenue Service to be used for fair and efficient administration of the revenue collection system." (2015 Information Reporting Program Advisory Committee (IRPAC) Public Report, 2015 Information Reporting Program Advisory Committee (IRPAC) Public Report). As the 1098 reporting provision coursed through Congress, the bill was viewed as one that would "materially assist the Internal Revenue Service in verifying the accuracy of the claimed mortgage interest deductions." [5] Clearly, any rule that promotes a schism between the amount of interest that a borrower pays to a lender from the amount of interest that lender reports on Form 1098 would lie across purposes with the intent of section 6050H.[6]

ambiguity. It is rather a recognition that the Service, as the primary administrative agency responsible for enforcing the tax code should be given an opportunity, should it wish to do so, to weigh in with its position before the Court decides the issue.

[5] H.R. Rep. 98-432, 1353, 1984 USCCAN 697, 1006 (March 5, 1984); S.Prt. 98-169, Vol. I, Senate Committee On Finance, Deficit Reduction Act of 1984: Explanation of Provisions Approved By The Committee On March 21, 1984, at 429, available at http://www.finance.senate.gov/library/prints/index.cfm?PageNum_rs=5&maxrows=25 (April 2, 1984); Joint Comm. on Taxation, H.R. 4170, 98th Cong; Public Law 98-369, Gen. Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 488 (Dec. 31, 1984), available at https://www.jct.gov/publications.html?func=startdown&id=3343.

[6] This is not to say that the amount of interest deducted by the taxpayer will always match the amount of interest reported on Form 1098. For instance, a borrower might pay less than $600 in interest and thus not receive a Form 1098, but that borrower could still deduct the interest that he or she did pay.

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Because taxpayers, their tax preparers, and the IRS all routinely rely on the amounts contained on the lender-issued Form 1098, if pre-existing interest is not reported on Form 1098, most borrowers (and their tax preparers) would never even know: (1) there is a pre-existing interest balance that can be deducted, or (2) how to allocate their mortgage payments to determine in which tax-year they have repaid the prior interest balance. While this may be "good" for the treasury, it is inconsistent with the principle that everyone pay only the amount of tax they are required to pay under the tax code. And, even for the few taxpayers (and tax preparers) that do understand what a deferred interest balance is, and who try to deduct those amounts, they will inevitably face (at least initially) resistance from the IRS because the amount of interest reported does not match the amount of interest stated on the lender-issued Form 1098.

These problems all completely disappear if banks simply report the "aggregate" amount of interest (both current and pre-existing) that they actually receive *as mandated by § 6050H.* If that happens, then the taxpayer will deduct the proper amounts and the Form 1098 will have served its *raison d'être* by helping the IRS to verify that the amounts deducted are proper.

And this is exactly what section 6050H contemplates. There is no ambiguity; its terms are simple, binary, and unambiguous. Recipients of "interest" on "any mortgage" are required to report on Form 1098 (to the IRS and to the payer) the "aggregate" amount of "interest" "received" during the calendar year if that amount "aggregates" to over $600. [7]

The Supreme Court has unequivocally held that the word "interest" in tax statutes is unambiguous. It means "the amount which one has contracted to pay for the use of borrowed money." *Old Colony R. Co. v. Comm'r. of Internal Revenue*, 284 U.S. 552, 560-561 (1932). See also *Deputy v. du Pont*, 308 U.S. 488, 497 (1940)). Here, even the

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[7] The actual text of the pertinent portion of 26 U.S.C. § 6050H provides that "Any person—

(1)who is engaged in a trade or business, and

(2)who, in the course of such trade or business, receives from any individual interest aggregating $600 or more for any calendar year on any mortgage,

shall make the return described in subsection (b) with respect to each individual from whom such interest was received at such time as the Secretary may by regulations prescribe.

ABA letter concedes that the pre-existing interest balances that are capitalized in the loan modification process are "interest." See ABA letter at p. 2.

Significantly, section 6050H does not contain any exceptions, exclusions, or other type of qualifying language excluding particular kinds of "interest." Nor is any type of mortgage excluded from its reporting requirement. Indeed, Congress's inclusion of the word "aggregate" in the language of the statute is clear evidence that all types of interest are to be totaled together at the end of the year and included in the recipient's Form 1098 reporting.[8]

*Copeland v. C.I.R.*, 2014 WL 5483046 (Tax Ct. 2014) also expressly holds that pre-loan modification interest retains its character as mortgage interest even after a loan modification and is therefore deductible by taxpayers in the year of repayment:

> Through the loan modification agreement, the $30,273 in past-due interest on petitioners' mortgage loan was added to the principal ["capitalized"]. Because petitioners did not pay this interest during 2010 in cash or its equivalent, they cannot claim a deduction for it for 2010. ***They will be entitled to a deduction if and when they actually discharge this portion of their loan obligation in a future year***" (emphasis added).[9]

*Id.* at 2014 WL 5483046 *2.

The principal of tax law that *Copeland* relies upon is not new, nor is there any ambiguity in it. Indeed, even as far back as 1970, the Tax Court in *Motel Corporation v. Comm. of Internal Revenue*, 54 T.C. 1433 (1970) found in the context of late-paid interest (which was then capitalized by the lender and added to principal) that it retained its

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[8] An "aggregate" means a sum which is "formed or calculated by the combination of many separate units or items." See Google dictionary (https://www.google.com/search?q=aggregate&rls=com.microsoft:en-US:IE-Address&ie=UTF-8&oe=UTF-8&sourceid=ie7&rlz=1I7MXGB_enUS525&gws_rd=ssl), last accessed on October 30, 2015.

[9] *Greenwood Packing Plant v. Commissioner*, 131 F.2d 787, 789 (4th Cir. 1942) is relevant when it states: "But it is more important to bear in mind that the system of taxation embraced in the income tax statutes does not permit a taxpayer to report income at will in any year he may select, but requires him to report it in the year in which it is received." If income must be reported "in the year in which it is received," no different rule should apply to reporting the receipt of interest; it should also be reported in the year in which it is paid. This is especially true when section 6050H emphasizes that recipients should report the "aggregate" amount of interest they receive during a calendar year.

character as interest. As that court emphatically put it: "we can perceive *no reason* why defaulted interest should be transformed into principal for purposes of tax law." *Id.* at 54 T.C. 1440. (Emphasis added). In the context of a "negative amortization" pay option ARM loans, the Tax Court in *Smoker v. C.I.R.*, 2013 WL 645265 (Tax Ct. 2013) also squarely held that deferred interest does not lose its character as mortgage interest simply because it is capitalized and added to principal; rather, capitalized interest is deductible in the year of payment. *Id.* at 2013 WL 645265 *4.

Revenue Ruling 77-135, governing the treatment of deferred interest paid on "Graduated Payment Mortgages" ("GPMs"), also supports plaintiffs' position that there is no ambiguity concerning the fact that capitalized mortgage interest does not lose its character as mortgage interest simply by being added to principal. GPMs are negative amortization loans like that which was at issue in *Smoker*, but instead of offering the customer an "option" to pay less than the interest due in any given month, they instead provide for a fixed schedule of payments which, in the early years of the mortgage, are for less than the interest actually due, but as the mortgage term continues, the payments "graduate" to recover the interest that was previously deferred. Revenue Ruling 77-135 explicitly holds that for cash basis taxpayers like the overwhelming majority of taxpayers, "...when the amount of the payments has increased to the extent that it now exceeds the current interest charge owed, the excess... will be treated as discharging first that part of the unpaid balance of the loan that represents accumulated interest carried over from prior years and will be included in income by the mortgagee *and deducted by the mortgagor* ***as interest*** *at that time*" (emphasis added).

The significance of this Revenue Ruling cannot be marginalized because it does not directly involve loan modifications. "A revenue ruling is the Service's official conclusion about how the internal revenue laws, related statutes, tax treaties, and regulations apply to a specific set of facts, and is published by the Service in the Internal Revenue Bulletin." (Saltzman & Book: IRS Practice & Procedure (WG&L)). "Taxpayers generally may rely upon revenue rulings and revenue procedures published in the Bulletin in determining the tax treatment of their own transactions *and need not request specific rulings* ***applying the principles*** *of a published revenue ruling or revenue procedure to the facts of their particular cases.*" Rev. Proc. 89-14, § 7.01(5), 1989-1 CB 814. See also Rev. Proc. 2004-1, § 2.05, 2004-1 IRB 1.

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Since there is already a revenue ruling applying the ***principle*** that capitalization of interest does not change its character as interest, and since section 6050H unambiguously requires that all types of interest be "aggregated" as part of the Form 1098 reporting calculation, there is no reason for the Service to provide any further "guidance" on the ABA's "question." The answer is plain for all to see.

Indeed, this is exactly what the Service found when it enacted 26 C.F.R. Section 1.221-2(h) – capitalized student loan interest (post 2004) should be reported on Form 1098-E along with current interest in the year in which it is paid. The Treasury Department's stated rationale for its determination that capitalized student loan interest should be reported on Form 1098-E in the year in which it is paid ***is exactly the same as we make here***, namely that:

> "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... Under the final regulations, a payment generally first applies to interest that has accrued and remains unpaid as of the date the payment is due and then applies to the outstanding principal.[10]

See 69 FR 25489-02, 2004 WL 972762 *25490. The instructions for filling out Form 1098-E also explicitly state that "interest" reportable on Form 1098-E "includes capitalized interest and loan origination fees that represent charges for the use or forbearance of money. See Regulations section 1.221-1(f)."

There is ***absolutely nothing*** to logically distinguish the reporting treatment of capitalized interest in the student loan context and the treatment of capitalized interest in the mortgage/loan modification context. Therefore, even if there was still some question of ambiguity remaining after Revenue Ruling 77-135 as to the treatment of capitalized interest, after 2004 no bank could *reasonably* claim that it needed further "guidance" on whether to report the payment of capitalized interest on an informational return.

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[10] See also *Estate of Paul M. Bowen v. Commissioner*, 2 T.C. 1 (1943) and *Motel Corporation, supra*, 54 T.C. 1440 (1970) which set forth the general rule that partial payments on a note are treated as first applying to interest and then to reduce principal."

It is no accident that *all* of the above authorities point to the same conclusion: the capitalization of mortgage interest and the adding of that amount to principal ***does not*** change its character as mortgage interest[11] and therefore is part of the "aggregate" interest that should be reported on Form 1098 by the "recipient" of that interest. It is also no accident that the ABA's letter contains no contrary authority; there isn't any.

### 3. The IRS Cannot Issue Blanket "Guidance" On When Interest Should Be Reportable Because The Language Of Loan Contracts Can Differ On Allocation Of Payments

An issue completely ignored by the ABA in its letter is that creditors and debtors are generally free to allocate payments on an indebtedness between principal and interest in the manner in which they agree, at least where that arrangement is *bona fide*. It is only absent such an arrangement that payments are first allocated to accrued but unpaid interest and then to principal. *Prabel v. Commissioner*, 91 T.C. 1101, 1113 (1988), affd. 882 F.2d 820 (3d Cir.1989); *Bayou Verret Land Co. v. Commissioner*, 52 T.C. 971, 985–986 (1969), affd. on this issue 450 F.2d 850 (5th Cir.1971); *Huntington–Redondo Co. v. Commissioner*, 36 B.T.A. 116 (1937); *Mason v. United States*, 453 F.Supp. 845, 848 (N.D.Cal.1978). See also TAM 7932002, 1979 WL 55145 ("Agreed allocations of payments to principal before interest are recognized because realistically such allocations do nothing more than defer the payment of interest by borrowers and the receipt of interest by the lenders.")

Thus, if one ABA member's loan agreement has a provision stating that payments of interest will only be credited after all of the principal is paid off, and another has the opposite provision – that interest payments will be credited first – then their Form 1098 reporting obligations will be completely different even if the rest of the loan terms are identical. The ABA blindly ignores this subtlety in favor of wanting a blanket one-size-fits-all (prospective only) guidance.

[11] While all mortgage interest is potentially deductible, there are limits to the availability of the deduction, such as mortgage interest accrued on mortgage debt of over $1,000,000.

### 4. There Is Nothing Special About Loan Modifications That Would Change The Rules With Respect To How Payments Of Capitalized Interest Should Be Reported On Form 1098

#### A. Loan Modifications Are Not "New Loans"

The ABA's letter repeatedly, and misleadingly, uses the term "new loan" with reference to loan modifications. It does so because where a borrower *truly* obtains a new loan, then all of the pre-existing interest is paid off and there is no question of reporting payments of pre-existing interest. **But a loan *modification* is not a "new loan."** It is a modification of an existing loan. And, in a loan modification, pre-existing interest is not paid off, but is capitalized and thus cannot be made to simply "disappear" for the bank's convenience.

It is a "fundamental proposition of tax law that in determining the tax treatment of a transaction, substance governs form." *Gregory v. Helvering*, 293 U.S. 465, 470 (1935). In fact, it was based on this very premise that *Copeland* held that loan "modifications" are not "new notes" for purposes of calculating mortgage interest:

> [P]etitioners ask us to recharacterize their loan modification transaction. Instead of having modified the terms of their existing loan, petitioners say they should be treated as if they had obtained a new loan from a different lender and used the proceeds of that loan to pay both the principal of the Bank of America loan and the past-due interest... Contrary to petitioners' "substance over form" argument, the transaction they hypothesize is not economically equivalent to the transaction in which they engaged... In any event, it is well established that taxpayers must accept the tax consequences of the transaction in which they actually engaged, even if alternative arrangements might have provided more desirable tax results.

*Id.* at *3.

The ABA likewise should not be allowed to recharacterize the loan modification transactions in which its member "actually engaged" into "new loans." Loan modification agreements all make very clear that the transaction is not intended to create a "new note," but is intended to "amend" and/or "supplement" the original note. They also all require their borrowers to continue to comply with all of the requirements of the

original notes except for the specifically modified provisions. But what really puts the lie to the ABA's "new loan" claim is that the loan modification agreements themselves expressly declare that they are not to be so construed. For example, Bank of America's loan modification form states that "Nothing in this agreement shall be understood or construed to be a satisfaction or release in whole or in part of the Note (referring to the original note) and Security Instrument (referring to the original deed of trust)." Bank of America also, notably, continues to use the same "old" loan number post modification and we are certain other lenders do as well. There is no way given the text of the loan modification agreements that any borrower would ever anticipate that banks would take the position that the agreements they signed were modifications in every respect except that they were entering into "new loans" for the purpose of pre-existing interest. Nor did any of the loan modification agreements advise borrowers that the banks would not be reporting this interest on Form 1098 and that they would effectively be giving up their mortgage deduction or, at the very least, forcing them to battle with the Service every year because their stated deductions would not match the Form 1098 issued by their lender.

Further demonstrating that plaintiffs' loan modifications are not "new notes" is that no new TILA disclosures under 15 U.S.C. §§ 1631, 1632, 1635 and 1638 are given to loan modification recipients. 12 C.F.R. § 226.20 requires that new TILA disclosures must be given when a lender enters into a subsequent transaction with an existing borrower; it provides that where the subsequent transaction amounts to replacing the original obligation with a "new obligation," then the subsequent transaction is a "refinancing" and new TILA disclosures must be provided. The Official Staff Interpretation, Supp. I to 12 C.F.R. § 226.20(a) confirms that only "the cancellation of [the original] obligation and the substitution of a new obligation amount to a refinancing." And that:

A refinancing is a new transaction requiring a complete new set of disclosures. ***Whether a refinancing has occurred is determined by reference to whether the original obligation has been satisfied or extinguished and replaced by a new obligation, based on the parties' contract and applicable law.*** The refinancing may involve the consolidation of several existing obligations, disbursement of new money to the consumer or on the consumer's behalf, or the rescheduling of payments under an existing obligation. In any form, the new obligation must completely replace the prior one." (Emphasis added).

Thus, while the ABA members could certainly have offered their borrowers in distress "new loans", the fact is that they chose the entirely different route of loan modification and they did so for their own interest. Having done so, they must live with that choice. [12]

### B. Loan Modifications Are Not Governed By Revenue Ruling 70-647, 1970 C.B. 38 And So It Is Not The Borrowers' Responsibility To Track Their Payments of Capitalized Interest

Revenue Ruling 70-647, 1970-2 C.B. 38 does not allow banks to foist onto their borrowers the responsibility for tracking their payments of the interest they owed prior to their loan modification's taking effect, as Bank of America argued in the *Smith* case; That Revenue Ruling states that where a:

> lender accepts a ***new note***[13] (emphasis added) in payment of remaining principal and interest due on an existing note,... it is incumbent on the individual to keep his own record of [his payments of the part of the new loan balance that is interest accrued on the original loan].

By its very terms, the Ruling applies only where "a lender accepts a ***new note*** in payment, i.e. in full satisfaction of the remaining principal and interest due on [an] existing note." (Emphasis added). Indeed, the phrase "new note" *as a restriction* appears no fewer than 6 separate times in the text of the short Revenue Ruling.

Since the ABA's letter involves loan modifications and not "new notes," Revenue Ruling 70-647 has no direct application to the loan modification issue presented by the ABA letter.[14]

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[12] Many courts have held that loan modifications are not "new loans." See *Pickle v. Washington Mut. Bank*, 2011 WL 837867 at *3, fn. 1 (C.D.Cal. 2011) (no new extension of credit where loan forbearance agreement provided that "[a]ll of the original terms of [plaintiffs'] loan remain in full force and effect, unless specifically mentioned within this agreement"); *De Jose v. EMC Mortg. Corp.*, 2011 WL 1539656 at *7 (N.D.Cal. 2011); *Katz v. Cal-Western Rec. Corp.* 2010 WL 424453 at *4 (N.D.Cal. 2010); *Castrillo v. American Home Mortg. Servicing, Inc.* 670 F.Supp.2d 516, 527-528 (E.D.La. 2009); *Norton–Griffiths v. Wells Fargo Home Mortgage*, 2011 WL 61609 at * 5–7 (D.Vt. 2011); and *In re Sheppard*, 299 B.R. 753, 763-764 (Bkrtcy.E.D.Pa. 2003).

[13] This is clearly the source of the ABA "new" loan language. But quoting a phrase does not necessarily make it fit.

[14] Nor can 26 C.F.R. § 1.001-3(b) be relied upon to pull loan modifications within the scope of this Revenue Ruling.

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That said, the Ruling is consistent with all of the other authorities cited herein – that there is no ambiguity about the fact that payments of previously deferred interest should be reported in the year of actual payment. The ruling begins with the general rule (which is consistent with the language of the standard underlying loan agreements) that payments received by the lender should first be applied to reduce interest. It then establishes the principle that the mere giving of a note doesn't satisfy the "payment" requirement to deduct interest. So, in the hypothetical fact pattern presented in the Ruling, the taxpayer wasn't entitled to the $5 deduction in 1969, but was entitled to it in 1970 when he actually paid the interest. Clearly, then, if section 6050H had been in effect at the time, and if the loan at issue in the example was a mortgage that was modified, the lending bank would have been required to issue a Form 1098 showing a $5 interest payment for 1970.

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26 C.F.R. § 1.001-3(b) "provides rules for determining whether a modification of the terms of a debt instrument results in an exchange ***for purposes of § 1.1001–1(a)***." (Emphasis added). Since 26 CFR § 1.001-3(b) explicitly states that it only applies "*for purposes of* § 1.1001–1(a)," the "exchange" it talks about has no bearing on whether plaintiffs' loan modifications constitute "new notes" for the entirely separate purpose of section 6050H reporting, or, for that matter, pulling them within the scope of Revenue Ruling 70-647.[14] See *Northern Plains Resource Council v. U.S. E.P.A.*, 645 F.2d 1349, 1355 (9th Cir. 1981) (where a statute explicitly states that it applies "for purposes of" another statute, then Congress means its application to be limited to that statute alone). See also *Hanna v. U.S.*, 68 Ct.Cl. 45, 1929 WL 2486 at *5 (1929) holding that the *Northern Plains* rule applies to the United States tax code:

> It will be observed that this provision applies only to "deductions allowed individuals" *and that it is only "for the purpose of this paragraph."* The purpose of the paragraph was the allowance of deductions of taxes which had accrued, and for this purpose, *and this purpose only*, it is provided that estate taxes shall accrue on the due date thereof. The clear implication is that elsewhere the word "accrue" should be taken, when applied to taxes, as meaning the time when they were imposed or established as a liability by the law, at least unless the context otherwise indicates. In fact, it would seem that the maxim *expressio unius est exclusio alterius* here applies, *the statute having specifically stated that for the purposes of making deductions estate taxes should accrue on the due date thereof, excludes this meaning for other purposes*--***that is, for the purposes of the remainder of the act.*** Broom's Legal Maxims 664. The maxim is a rule of construction. (Emphasis added).

26 CFR § 1.860G-2 also shows that the "significant modification" test in § 1.001-3(b) does not apply to pull loan modifications within the Revenue Ruling. Section 1.860G-2 contains rules for determining whether an obligation is principally secured by an interest in real property and for determining whether loans that originally qualified as being secured by an interest in real property continue to qualify as such after a loan is modified. Rather than relying upon the definition of "exchange" and "significant modification" appearing in 26 CFR § 1.001-3(b), section 1.860G-2 has its own *different* definition of these terms. See 26 CFR § 1.860G-2(b)(2) and (3). In short, even if the loan modifications the ABA letter is talking about qualify as "exchanges" for purposes of 26 CFR § 1.001-3(b), it does not make them "new notes" for purposes of the Revenue Ruling. In short, 1.001-3(b) only applies to the banks' internal accounting, not to the accounting of its borrowers.

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Having already addressed the fundamental question back in 1970, and provided the Service's guidance, there is no reason the IRS should devote resources now to the same issue.

**5. Conclusion**

As can be seen from all of the above, there is *overwhelming* legal authority that: (1) 26 U.S.C. Section 6050H unambiguously requires recipients of more than $600 in mortgage interest to report the "aggregate" amount of the interest they receive during the calendar year, i.e. the sum of all types of interest they receive; (2) capitalizing mortgage interest and adding it to principal does ***not*** change its character as mortgage interest so that, just as with student loans, payments of capitalized interest must be reported on Form 1098 when it is paid; and (3) loan modifications do not present any exception to this rule; they are not new loans, but are just what they purport to be: modifications of existing loans. The ABA has offered no authority in its letter that would support an alternative view. Thus, there is no need for further "guidance" on what is a well-worn set of bedrock principles of tax law.

If the IRS determines to issue "guidance," however, it should make clear in doing so that its guidance is a restatement of existing law. And, given the clarity of the law, there is no reason that the Service should aid the banks in the currently pending litigation by declaring an ambiguity that does not exist.

There is one issue, however, in which we agree with the ABA. We also hope that the Service will do whatever it can to allow tax-payers to obtain the benefit of the billions of dollars in tax deductions that at least some of the ABA member banks have chosen (and "chosen" is a very deliberate word) to deny them out of their desire for expediency and cost reduction.

Finally, as we are "interested" parties, we would like to be part of any meetings or telephone conferences that might be scheduled to discuss these issues with any of the representatives of the ABA. We would also like to be copied on any other interested parties' responses or other letters that the Service sends or receives from these parties addressing the points raised by the ABA letter.

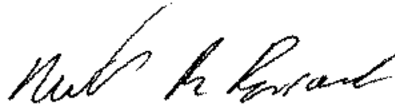
Should anyone from the Service wish to speak to us, they can call David Vendler at the phone number set forth above or you can call his cell phone number is (213) 700-5194. He can be reached anytime.

Yours,

MORRIS POLICH & PURDY LLP

David Vendler

MICHAEL R. BROWN, APC



Michael R. Brown

cc: Blaise Dusenberry
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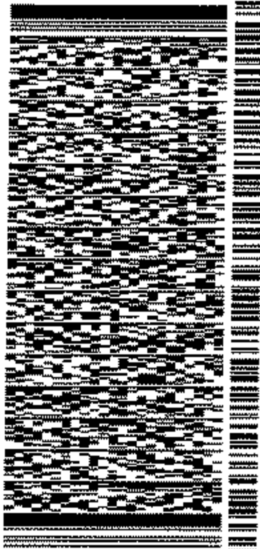

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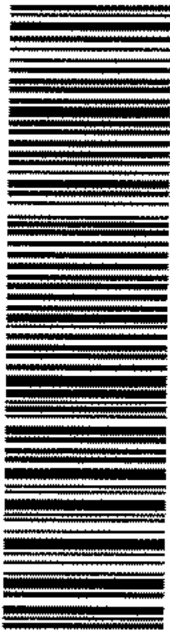

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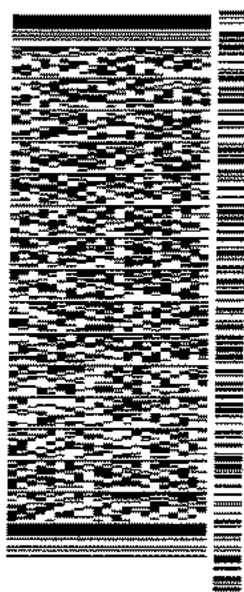

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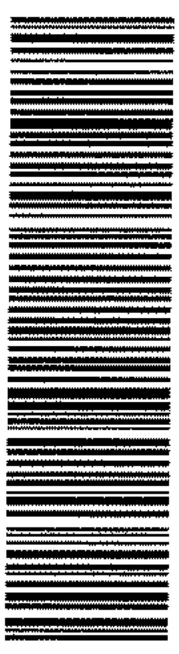

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