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Issue Contents

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HANDLING SHARED APPRECIATION MORTGAGES

— by Neil E. Harl[*]

The Agricultural Credit Act of 1987[1] authorized shared appreciation agreements (up to 10 years in duration) for debt structurings.[2] The appreciation recapture was set at 75 percent of any appreciation in fair market value of the collateral if, within four years, the loan is paid off, the borrower ceases farming or the borrower transfers the property.[3] The borrower pays 50 percent of any appreciation if the triggering event occurs after four years or, if not, upon termination of the agreement (up to 10 years).[4] Currently, more than 11,900 shared appreciation agreements have been executed on debt write-down of over $1.7 billion.[5] Approximately 6500 of the agreements are currently in effect and will become due over the next 10 years.[6]

A major concern is how to handle payments under the shared appreciation arrangements.

Proposed regulations

The Farm Service Agency (FSA) has proposed three changes to the regulations already in place dealing with shared appreciation arrangements—(1) the term of new shared appreciation agreements would be reduced to five years;[7] (2) allowance would be made for capital improvements made to property covered by an existing or future shared appreciation agreement under FSA direct loans (the value of improvements made to the collateral after the shared appreciation agreement was entered into could be deducted for purposes of calculating appreciation in value);[8] and (3) the interest rate charged on shared appreciation loans would be reduced from the current nonprogram rate to near the federal borrowing rate (the rate would be the "Farm Program Homestead Protection Rate."[9]

Comments on the proposed regulations are due by January 10, 2000.[10]

Interim regulations providing relief

On April 23, 1999, The Farm Service Agency announced, in interim regulations, that borrowers with shared appreciation agreements ending in 1999 and 2000 who have not paid their obligation or made arrangements to pay and cannot now pay the amount owed are allowed to have part or all of the obligation suspended for one year.[11] If USDA determines that the borrower still cannot pay after one year, the suspension may be renewed not more than twice.[12] During the suspension period, the obligation accrues interest at the federal borrowing rate.[13] Apparently, the suspension does not change the calculation of the amount owed (does not change the date for calculating property values, for example).

Handling payments

If, after the write down or buy-out of a farm loan, the FSA borrower makes a payment under a shared appreciation agreement, the borrower generally is permitted

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an adjustment that reverses the tax treatment accorded (under I.R.C. Section 108) to the indebtedness discharged by the write-down or buyout.[14] The order of the reversal is prescribed—

> "The ordering of this reversal of tax consequences operates as follows: To the extent that the amount discharged gave rise to discharge of indebtedness income that was not excluded under section 108 of the Code, a payment made under an SAA or a Recapture Agreement is first treated as a repayment of the amount discharged, and the borrower is permitted a deduction under section 162 of the Code. Then, to the extent the borrower excluded income under the qualified farm indebtedness exclusion and reduced a tax attribute or basis in property, the attribute or basis is restored. If the borrower has disposed of the property for which basis was reduced under the qualified farm indebtedness exclusion, the borrower is permitted a corresponding deduction or loss. Next, to the extent the borrower excluded income under the insolvency exclusion, but did not have to reduce basis in property because of the limitation under section 1017(b)(2), no deduction, loss, or increase in basis or attributes is permitted. Next, if the borrower excluded income under the insolvency exclusion and reduced a tax attribute or basis in property, the attribute or basis is restored. If the borrower has disposed of the property for which basis was reduced under the insolvency exclusion, the borrower is permitted a corresponding deduction or loss. Finally, if the borrower excluded an amount from income under the provisions of section 108(e)(2) because payment of the amount would have been deductible, the borrower is permitted a deduction of the same type (such as an interest deduction under section 163) for payment."[15]

Assuming the reversal is carried out as prescribed, and the amount of payment under the shared appreciation agreement exceeds the amount needed to reverse the original tax consequences under the write-down or buyout, there is relatively little authority on how the additional payment is to be handled. A 1983 ruling[16] allowed payments under a shared appreciation mortgage involving a residence to be deducted as interest. The ruling cautions that the conclusions may not apply to a commercial or business loan.[17] Shortly thereafter, IRS announced that no rulings or determination letters would be issued on any shared appreciation arrangement.[18] Legislation has been introduced (but not yet passed) to make "contingent interest on a shared appreciation mortgage on real property deductible" as interest.[19]

Under the circumstances, those reporting such additional payments as interest should disclose the details on the tax return.

FOOTNOTES

1 Pub. L. No. 100-233, 101 Stat. 1568 (1988). See generally 5 Harl, *Agricultural Law* § 39.03[3][b] (1999); Harl, *Agricultural Law Manual* § 4.02[15][b][ii] (1999).
2 See 7 C.F.R. § 1951.909.
3 Agricultural Credit Act of 1987, Pub. L. No. 100-233, Sec. 615, 101 Stat. 1678 (1988); 7 C.F.R. § 1951.909(e)(5).
4 *Id*.
5 7 C.F.R. § 1951.914, Oct. 31, 1999, 64 Fed. Reg. 61221, Nov. 10, 1999.
6 *Id*.
7 7 C.F.R. § 1951.914(b).
8 7 C.F.R. § 1951.914(c)(1).
9 7 C.F.R. § 1951.914(e)(6).
10 See 64 Fed. Reg. 61,221, Nov. 10, 1999.
11 64 Fed. Reg. 19,863, April 23, 1999.
12 *Id*.
13 *Id*.
14 Letter, Department of the Treasury, Internal Revenue Service, to Farmer Program Division, Farmers Home Administration, dated May 22, 1989, page 7 (reprinted as Appendix 39C, 5 Harl, *supra* n. 1 and as Appendix B in Harl, *Farm Income Tax: Annotated Materials*, all editions since 1989).
15 *Id*.
16 Rev. Rul. 83-51, 1983-1 C.B. 48.
17 *Id*.
18 E.g., Rev. Proc. 94-3, 1994-1 C.B. 447.
19 H.R. 4637, 105th Cong., 2d Sess. (1998).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

AVOIDABLE LIENS. The debtor had borrowed money from a bank and granted the bank a security interest in any federal farm program payments to be received by the debtor. The debtor suffered crop losses in 1998 and filed for assistance under the 1998 Crop Loss Disaster Assistance Program. The funds received under that program were deposited in the debtor's bank account and frozen by the bank. The bank sought relief from the automatic stay to collect those funds as security for the loan. The debtor argued that the bank did not have a perfected security interest because the bank had not obtained an assignment of the disaster payments under 7 C.F.R. § 1437.18. The court held that the assignment provision was intended only to protect the federal government and did not affect security interests between a debtor and creditor. The court held that the bank's security interest was perfected and allowed the bank relief from the automatic stay. ***In re* Endicott, 239 B.R. 529 (Bankr. E.D. Ark. 1999)**.

Agricultural Law Manual* **(ALM).