The Application of Payments on Distressed Debt, Considering Howland v. Commissioner

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I. Introduction

On June 13, 2022, the U.S. Tax Court released a memorandum opinion, *Howland v. Commissioner*,[1] which considered whether a couple was entitled to a home mortgage interest deduction after the foreclosure of their home. The Tax Court holdings and analysis are significant for two reasons.

First, the opinion includes some discussion that may indicate the Tax Court's position regarding the application of payments on distressed debt instruments to principal and interest. In that regard, although the Tax Court acknowledged that clear evidence that payments were applied to interest could support a finding that the borrowers paid home mortgage interest, it required a relatively high degree of proof and placed significant emphasis on the legal application of payments. The Tax Court's opinion also considered, and distinguished, traditional case law considering the application of payments on a debt, but did not discuss the interest-first payment ordering rule under Reg. §1.446-2(e), which may imply that traditional case law continues to be relevant and Reg. §1.446-2(e) did not apply in the factual context considered by the court.[2] However, for a number of reasons, the implications of the *Howland* as to the application of payments on a debt are not entirely clear, as will be discussed below. Second, the Tax Court decision raises the question of how a taxpayer can demonstrate how the lender applied payments between principal and interest in cases where the lender does not issue an Internal Revenue Service (IRS) Form 1098, *Mortgage Interest Statement*.

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II. Background

In 2007, the Howlands executed a credit agreement with Haven Trust Bank, which provided for a line of credit with a maximum credit capacity of $390,000. The line of credit was secured by a mortgage on taxpayers' principal residence. This credit agreement was secondary to taxpayers' first mortgage loan held by

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Countrywide Home Loans. Under the terms of the credit agreement, any payments were to be applied first to interest and then to principal.

Since the taxpayers had not made any payments on the credit agreement, First Southern Bank, Haven Trust Bank's successor in interest, filed a foreclosure complaint with a Florida state court. In the foreclosure action, First Southern Bank sought an award from the circuit court for the full amount due from the taxpayers, including the right to foreclose on their home. The Florida court ruled in First Southern Bank's favor resulting in a foreclosure sale of the taxpayers' home. CenterState Bank, the successor to First Southern Bank, was the highest bidder at the foreclosure sale and acquired the residence with a bid of $321,000. Based on the judgement, at the time of the foreclosure sale, the sum of the accrued interest on the credit agreement was $100,607.

In June 2016, a second foreclosure complaint was filed in the circuit court by the first mortgage holder, Bank of New York Mellon, as successor in interest to Countrywide Home Loans. Bank of New York Mellon claimed a balance due of $247,046 that included principal, interest, late charges, attorney's fees, and other permitted expenses. In December 2016, CenterState Bank sold the taxpayers' house to third parties for $594,000. Although there was no clear indication as to how the proceeds of this sale were split between CenterState Bank and Bank of New York Mellon, the Tax Court generally accepted that the proceeds of the sale should go first to Bank of New York Mellon to satisfy its first-priority claim. This would mean that the amount received by CenterState Bank was $346,954, which was less than the principal amount outstanding of $377,060. No IRS Form 1098, *Mortgage Interest Statement*, was issued to the taxpayers for tax year 2016 for the home mortgage interest in question.

On their joint tax return for 2016, the Howlands claimed a home mortgage interest deduction in respect of the CenterState Bank debt.[3] After requesting additional documentation, the IRS examined the return and issued a deficiency notice disallowing the deduction and asserting an accuracy-related penalty under Code Sec. 6662(a).

III. The Parties' Arguments

The Howlands argued that the foreclosure of their mortgage constituted a taxable sale or exchange and that the home's fair market value should be treated as being equal to the price that a willing buyer paid shortly after the foreclosure. In addition, the taxpayers argued that pursuant to the terms of the credit agreement, the amount that CenterState Bank received from selling their home to a third party should be first applied to any outstanding interest owed and then to principal.

The IRS argued that, after payment of the first mortgage balance due to Bank of New York Mellon, the remaining proceeds from foreclosure did not cover the principal balance due to CenterState Bank. Accordingly, the IRS argued that no amount of interest was paid to CenterState Bank at the time of the foreclosure sale (*i.e.*, contrary to the taxpayers' contention, the IRS argued that payments should be applied first to principal).

IV. The Tax Court's Opinion

In deciding whether the Howlands paid any interest, the Tax Court discussed traditional case law governing the application of payments on a debt. The Tax Court cited *Lackey* and *Newhouse* as establishing a general payment ordering rule applicable to voluntary partial payments and an exception to this general rule for insolvent taxpayers.[4] Under the general rule, in the absence of any agreement between the parties, voluntary payments made by a debtor to a creditor are to be applied first to interest and then to principal.[5] However, citing *Newhouse,* the Tax Court indicated that an exception to that rule exists in the case of an involuntary foreclosure of mortgaged property where the mortgagor is insolvent at the time of foreclosure. The Tax Court held that neither the general rule nor the exception articulated in *Lackey* and *Newhouse* was directly applicable because the payments were involuntary, but there was no evidence that the Howlands were insolvent at the time of the foreclosure.[6] In addition, the credit agreement specifically stated that repayments on the note were to be applied first to interest and then to principal, which distinguished the facts of the case from both *Lackey* and *Newhouse*.

After determining that the *Lackey* and *Newhouse* precedents were distinguishable, the Tax Court concluded that there was not enough evidence on the record showing how CenterState Bank applied the funds received to support the taxpayers' claimed interest deduction. Thus, the Tax Court did not so much enunciate a rule that belied the taxpayers' contentions as it ruled against them on the basis of a lack of evidence. Underscoring the importance of supporting evidence, Tax Court Judge Christian N. Weiler wrote in relevant part "*[t]hese facts (if favorable) could support a finding that petitioners in fact paid home mortgage interest (in some amount)—rather than repaying principal balance*."[7] Although the Tax Court ruled that the Howlands weren't entitled to a mortgage interest deduction, the Tax Court did not find them liable for the accuracy-related penalties under Code Sec. 6662(a).

V. Implications of the Howland Decision

After the *Lackey* and *Newhouse* decisions were rendered, the Treasury Department promulgated Reg. §1.446-2(e), which provides (without qualification) that payments on a debt instrument are to be treated first as payments of interest to the extent of accrued but unpaid interest and second as a payment of principal, unless the payment meets the definition of a *pro rata* prepayment.[8] Although this rule makes perfect sense in the context of a performing loan, many have questioned whether it should be applied to distressed debt instruments. Because the Tax Court's opinion in *Howland* discusses *Lackey* and *Newhouse* in detail, it suggests that principles established by traditional case law have continued relevance. In other words, Reg. §1.446-2(e) may not be a rule of universal application.

Applying the "principal first" rule of traditional case law in the context of distressed debt would make sense based on the economic reality of distressed debt retirements. That is, a lender cannot be said to have received interest—traditionally defined a payment "for the use or forbearance of money"—if the lender does not even recover the entirety of what they lent.[9] This approach also accords with some informal guidance provided by the IRS after the promulgation of the Reg. §1.446-2(e) payment ordering rule[10] and would reconcile the application of payments with the doubtful collectability exception to interest accrual, which is generally applied once it becomes clear that interest is not expected to be collected.[11] Also, although Reg. §1.446-2(e) does not explicitly limit its application to performing loans, there is a technical argument that it does not apply to a payment in final settlement of a distressed loan because a negotiated settlement payment is not a payment "under a loan" but external to the loan.[12] Unfortunately, the Tax Court did not directly consider whether this is a relevant distinction, but its lack of discussion of Reg. §1.446-2(e) could be interpreted as implying that the regulation was not relevant in this context, which would be consistent with this argument.

However, viewing the Tax Court's analysis as a wholesale endorsement of traditional case law is complicated by the lack of discussion of Reg. §1.446-2(e) and the fact that it is a memorandum opinion. It is entirely possible that the Tax Court was not briefed on Reg. §1.446-2(e) and the potential applicability of that regulation was simply not considered. In addition, to the extent that the Tax Court's decision supports the ongoing relevance of the traditional case law, it would arguably be contrary, in some respects, to the Ninth Circuit Court's recent decision in *Milkovich v. United States*.[13] In that case, the Ninth Circuit implied, *in dicta*, that the payment ordering rule does apply in the context of distressed debt regardless of whether the taxpayer is insolvent.[14] For these reasons, it is difficult to draw definitive conclusions as to the application of payments from the *Howland* decision.

The Tax Court's analysis is also notable in that, once it had distinguished *Lackey* and *Newhouse*, it places significant emphasis on the legal application of proceeds rather than the economic substance of the short sale. The Howlands' creditor was not repaid in full, such that it is difficult to characterize a final settlement payment as interest—a form of income to the creditor, without elevating form over substance. Although the Tax Court's decision aligns with the substance of the transaction, that was not the driving factor behind the decision.

Finally, the Tax Court's decision is also interesting because, notwithstanding the emphasis on the legal application of the proceeds of the short sale, there is no analysis of whether the terms of the credit agreement might satisfy the taxpayers' burden of proof. As noted above, the credit agreement provided that payments were to be applied first against interest and second against principal. The IRS argued that this requirement was not applicable in the context of a short sale, and the IRS may have been correct in that regard, but the lack of analysis in the Tax Court's opinion makes the conclusion not feel fully supported. It is not entirely clear what types of evidence the Tax Court would have accepted to support the interest deduction and it would generally seem difficult for the taxpayers to provide evidence of how the lender actually applied the proceeds of the short sale. An IRS Form 1098, *Mortgage Interest Statement*, would certainly be helpful, but a taxpayer's ability to deduct a payment should arguably not hinge on the information reporting of a counterparty. Thus, the *Howland* decision creates uncertainty as to how taxpayers in similar situations should attempt to meet their burden of proof.

ENDNOTES

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1. *R.W. Howland, Jr.*, 123 TCM 1321, Dec. 62,066(M), TC Memo. 2022-60.
2. Based on the court's discussion of the parties' arguments, it is not clear whether the taxpayers argued that payments were required to be treated as payments of interest under Reg. §1.446-2(e).

[3] The taxpayers originally claimed a deduction in the amount of $103,498. In footnote 6, the Tax Court indicated that it was not clear how the $103,498 interest deduction was calculated and that the taxpayers were seeking a revised deduction in the amount of $100,607 (*i.e.*, the amount of accrued interest at the time of the foreclosure sale).

[4] *E.G. Lackey*, 36 TCM 890, Dec. 34,500(M), TC Memo. 1977-213; *G.R. Newhouse*, 59 TC 783, Dec. 31,885 (1973).

[5] This general rule is similar to the payment ordering rule subsequently promulgated in Reg. §1.446-2(e), discussed below.

[6] In other words, the general rule, which applies to voluntary payments, did not apply because the payment was made pursuant to foreclosure proceedings and was involuntary. The exception articulated in *Newhouse*, which applies to involuntary payments made by insolvent taxpayers, also did not apply because it was not demonstrated that the taxpayers were insolvent.

[7] *R.W. Howland, Jr.*, 123 TCM 1321, Dec. 62,066(M), TC Memo. 2002-60, at 5 (emphasis added).

[8] *See also* Reg. §1.1275-2(a)(1) ("each payment under a debt instrument is treated first as a payment of OID to the extent of the OID that has accrued as of the date the payment is due and has not been allocated to prior payments, and second as a payment of principal").

[9] *See P.E. Deputy v. P.S. du Pont*, SCt, 40-1 USTC ¶9161, 308 US 488, 498, 60 SCt 363 (1940).

[10] For example, LTR 8821018 (Feb. 23, 1988) concludes that the final payment on tax-exempt bonds not in excess of principal should be allocated to principal regardless of whether any agreement between the borrowers and lenders stating otherwise. This letter ruling is interesting in that it was issued two years after the payment ordering rules were issued in proposed form. *See* Proposed Reg. §1.446-4(d)(1), 51 FR 12022, 12032 (Apr. 8, 1986) ("Each payment under a loan ... shall be treated first, as a payment of interest to the extent of the accrued and unpaid interest ... as of the date the payment becomes due"). In LTR 200035008 (Sep. 1, 2000), which was issued after Reg. §1.446-2(e) was finalized, the IRS cited *Newhouse* for the proposition that payments should be applied first against principal and second against interest in cases where there is an involuntary foreclosure of mortgaged property, and strong evidence indicates that the mortgagor is insolvent, because the payment on the debt is less than its outstanding principal amount. Similar to the Tax Court's decision in *Howland*, neither LTR explicitly addresses Reg. §1.446-2(e).

[11] *See, e.g., Corn Exchange Bank*, CA-2, 2 USTC ¶455, 37 F2d 34, 34 (1930) ("A taxpayer, even though keeping his books upon an accrual basis, should not be required to pay a tax on [interest] unless it is good and collectable, and, where it is of doubtful collectability or it is reasonably certain it will not be collected, it would be an injustice to the taxpayer to insist upon taxation."); Rev. Rul. 80-361, 1980-2 CB 164 ("The interest, the right to which became fixed during that part of 1976 after A's insolvency, did not properly accrue, since the interest was uncollectible at the time such right arose.").

If the Reg. §1.446-2(e) payment ordering rule applied to distressed debt, a taxpayer would only be able to assert that interest was not reasonably expected to be collected once the interest included in taxable income exceeds all expected remaining payments on the debt. In practice, the doubtful collectability exception is generally applied once it becomes clear the taxpayer will not receive payments exceeding the amount of principal and previously accrued interest. *See* David C. Garlock and Matthew S. Blum, *Unresolved Creditor Issues in Debt Workouts*, J. TAXATION FINANCIAL PRODUCTS 1, 3 (Oct. 1, 2000) ("Note that, at least in theory, [the doubtful collectability exception] does not require that the debt itself be uncollectible, only that the interest be uncollectible.").

[12] *See* DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS ¶1602.02.

[13] *L. Milkovich*, CA-9, 2022-1 USTC ¶50,121, 28 F4th 1 (2022).

[14] *Milkovich* involved a similar set of facts wherein a couple purchased a home and took out a mortgage in connection with that purchase. A few years later, the couple jointly filed for Chapter 7 bankruptcy. The taxpayers received a discharge from the bankruptcy court and the bank's lien was essentially converted from a recourse obligation to a nonrecourse obligation secured only by the taxpayers' residence. In a subsequent short sale, the couple's home was sold for an amount less that the outstanding balance on the secured loan. The bank issued an IRS Form 1098, *Mortgage Interest Statement*, indicating the amount of interest payments from the taxpayers and the taxpayers deducted that amount on their joint tax return. The IRS issued a notice of deficiency, stating that the couple "*did not establish ... the* amount *of ... (a) interest expense, and (b) [whether interest] was paid.*" 28 F4th at 5 (emphasis added).

The Ninth Circuit held in favor of the taxpayer primarily because the settlement of the nonrecourse debt through a short sale is a gain generating transaction in which the borrower is treated as realizing an amount on the sale of the subject property equal to the full amount of the outstanding liability and paying the amount realized over to the lender in satisfaction of the debt. However, *in dicta*, the Ninth Circuit court discussed the payment ordering rule under Reg. §1.446-2(e)(1) and noted that even if the debt were not treated as having been satisfied in full, this rule would support treating payments first as payments of interest and second as payments of principal.

It should be noted that even the *Milkovich dicta* is difficult to interpret as entirely rejecting the ongoing relevance of traditional case law, because the Ninth Circuit's decision also relied upon previous decisions, such as *P.E. Cantalano*, 79 TCM 1632, Dec. 53,792(M), TC Memo. 2000-82, which discusses *Lackey* and seems to regard it as having continuing relevance.

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