Is Sharif's Castle Deductible? Islam and the Tax Treatment of Mortgage Debt

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ABSTRACT

This Article examines the tax treatment of Islamic mortgage alternatives and considers the cultural and constitutional implications of the tax treatment of mortgage debt. Islamic law cannot be separated from the religion of Islam, and one of the primary tenets of Islamic law is the prohibition of *riba*, which is defined by some Islamic jurists as the payment of interest on any loan. Financing institutions, working with Muslim religious leaders, have developed a number of financing instruments that do not violate the prohibition against *riba*, thus facilitating home ownership for those Muslims who do not feel comfortable with a traditional mortgage. Should payments under such instruments qualify for the home mortgage interest deduction? What are the potential consequences of either permitting or denying a deduction for such payments? This Article discusses the constitutional implications of denying a tax deduction and administrative and regulatory options to accommodate tax deduction of payments under Muslim mortgage alternatives. Finally, this Article concludes that the issue of religious discrimination in the tax treatment of housing should be among the motivating factors for a statutory remodeling of the home mortgage interest deduction.
Muslims that follow the interpretations of certain Islamic jurists believe that the payment or receipt of interest (riba) is contrary to Islamic law.¹ The prohibition on riba is found in Islamic law, shari’a.² Shari’a is derived from the Qur’an, as interpreted by Muslim scholars.³ While some scholars interpret the Qur’an to mean that all interest is prohibited,⁴ others argue that restricting non-usurious interest results in unfairness, which is itself contrary to the Qur’an.⁵

While scholars debate, American Muslims want to buy homes. Like other Americans, they seek financing for the purchase. For non-Muslim Americans, obtaining financing for a home purchase is a relatively straightforward affair. They get a mortgage. Together with the mortgage, they get a gift from the U.S. government: the ability to deduct their mortgage interest payments from their taxable income.⁶ For

¹ The abolition of interest is a key element of an ideal Islamic economy. See FARHAD NOMANI & ALI RAHNEMA, ISLAMIC ECONOMIC SYSTEMS 103 (1994); see also BILL MAURER, PIOUS PROPERTY: ISLAMIC MORTGAGES IN THE UNITED STATES 25 (2006) (“Islamic banking and finance begins from the Qur’anic injunctions against riba.”).
² NOMANI & RAHNEMA, supra note 1, at 43.
³ Id. at 45. Shari’a is also derived from “the utterances or examples of Muhammad known as hadith.” Haider Ala Hamoudi, Jurisprudential Schizophrenia: On Form and Function in Islamic Finance, 7 CHI. J. INT’L L. 605, 608 (2007) (citing Cherif Bassiouni & Gamal Badr, The Shari’ah: Sources, Interpretation, and Rule-Making, 1 UCLA J. ISLAMIC & NEAR E. L. 135, 138–39 (2002)).
⁴ “[R]iba has become synonymous in the modern era with interest of any kind on a loan.” Haider Ala Hamoudi, Muhammad’s Social Justice or Muslim Cant?: Langdellianism and the Failures of Islamic Finance, 40 CORNELL INT’L L.J. 89, 113 (2007). Professor Hamoudi does not agree with this interpretation. Rather, he concludes that “Islamic finance results in a system rife with unnecessary complexities and inconsistencies, decidedly more expensive than its standard commercial analogues and more deceptive given its highly exaggerated assertions of fairness, equity and, in some cases, charity.” Id. at 133.
Muslims who believe that paying interest compromises their religious beliefs, "non-interest" home purchasing financing options are available. However, these Muslim home buyers are on the horns of a dilemma: to comply with the tenets of their religion, they cannot pay interest. But to obtain a deduction from the U.S. government, their payments must be in the form of interest.

While this issue may appear to be narrowly confined to the acquisition of homes by certain Muslim Americans, it raises broader concerns. Should the tax system be altered to provide additional fairness to those exercising their constitutional right to freely practice their religion? Should the efficient administration of the tax system outweigh those concerns? How should the legal and cultural preference for home ownership factor into the resolution?

Financial institutions, with the blessing of Muslim religious leaders, have developed a number of financing instruments that comply with shari'a and facilitate home ownership for some Muslims. This Article will consider whether payments under such instruments should qualify for the home mortgage interest deduction and the potential consequences of either permitting or denying a deduction for such payments. The question of whether a home-owner should attempt to deduct as interest a payment under an Islamic mortgage alternative, from a religious perspective, is not one that I am qualified to discuss. Accordingly, this Article will analyze the issue of the tax treatment of these payments without considering the potential religious conflict of taking the deduction.

First, I will discuss the importance of home ownership from a cultural and legal perspective. Next, I will discuss the provenance of the home mortgage interest deduction. Then, I will discuss the Muslim mortgage alternatives and compare them to traditional mortgages: from both an economic and tax perspective. Then I will discuss administrative and regulatory options to accommodate tax deduction of payments under Islamic mortgage alternatives. Finally, the issue of religious discrimination in the tax treatment of housing provides another impetus for remodeling the home mortgage interest deduction—into a shelter credit available to renters and owners alike.

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7 See infra Part IV.
8 See infra Part III.
9 This issue is reminiscent of Comm'r. v. Duberstein, 363 U.S. 278 (1960), the seminal Supreme Court decision on the definition of gift for tax purposes. The value of a gift is not included in gross income. I.R.C. § 102(a) (2006). The motive of the giver is the key to gift treatment—if the giver has donative intent, the transfer is a gift. Duberstein, 363 U.S. at 285–86. Duberstein received a Cadillac from a business acquaintance to whom he had referred customers. Id. at 280–81. In arguing that the Cadillac did not constitute a gift, the IRS noted that the giver of the Cadillac had taken a business expense deduction. Id. at 281. Justice Brennan found that the giver's hopes of deducting the value of the Cadillac had nothing to do with whether it was considered a gift. Id. at 286. Justice Brennan was, in effect, taking judicial notice that everyone likes a tax deduction, whether or not the underlying motive is pure altruism. Accordingly, I will not consider whether taking a deduction for a payment under an Islamic mortgage alternative obviates the desired religious benefit, because, obviously, everyone likes a tax deduction.
I. ECONOMIC IMPACT OF MUSLIM HOME OWNERSHIP

The actual size of the U.S. Muslim population is difficult to determine, as the U.S. Census is prohibited from collecting religious information. The Pew Research Center estimates that there are 1.4 million adult Muslims living in the United States. Other studies place the Muslim population at between three and nine million, with an average of 6.7 million. Seventy-two percent of American Muslims say that "religion is very important" in their lives. Muslim American family income roughly tracks that of the population as a whole: 41% of Muslim American families report household income of $50,000 or more, versus 44% of the population nationwide. Sixteen percent of Muslim Americans report household incomes of $100,000 or more, versus 17% of the population nationwide. In 2005, 68.8% of Americans owned their homes. Approximately three-quarters of home purchasers finance the purchase. Thus, using the most conservative population estimate, we can assume that over 700,000 American Muslims use some sort of financing to acquire their homes. If 72% percent of those Muslim home-owners who used financing believe religion to be very important and those home-owners agree with those jurists who hold that interest is riba, they may have used or wished to use Islamic financing alternatives. Under these admittedly speculative figures, over 500,000 homes purchased by American Muslims could have potentially used Islamic financing alternatives. In 2005, the

12 TOM W. SMITH, ESTIMATING THE MUSLIM POPULATION IN THE UNITED STATES (2001), available at http://cloud9.norc.uchicago.edu/dlib/muslm.htm. Smith concludes that the best available estimates place the U.S. Muslim population between 1.9 and 2.8 million. Id.
13 PEW RESEARCH CENTER, supra note 11, at 8.
14 Id. at 18.
15 Id.
17 RACHEL BOGARDUS DREW, BUYING FOR THEMSELVES: AN ANALYSIS OF UNMARRIED FEMALE HOME BUYERS 29 tbl.1 (2006).
18 Calculation: 1.4 million Muslim Americans x 68.8% home ownership rate x 75% acquisition financing = 722,400 Muslim American homes purchased using acquisition financing. One article suggests that due to the difficulty in obtaining shari’a compliant financing, Muslim home ownership rates may be significantly lower than those of the general population. See Patrick O’Gilfoil Healy, For Muslims, Loans for the Conscience, N.Y. TIMES, Aug. 7, 2005, at J1 (noting that Michigan census figures indicate that Muslim home ownership in the state lags statewide percentage ownership by 7%).
19 See, e.g., Dina ElBoghdady, Merging Faith, Finance: Growing Number of Firms Respond to Islamic Rules on Paying Interest, WASH. POST., Oct. 21, 2006, at F1 (describing Muslim home-owners who are converting their conventional mortgages to shari’a compliant alternatives); Healy, supra note 18.
20 Calculation: 72% x 722,400 homes = 520,128 homes.
home mortgage interest deduction provided the equivalent of $72.6 billion in government subsidies to home-owners.21 Accordingly, if all Muslim home-owners who wished to use Islamic financing alternatives did so, and if they were not allowed to take a deduction for their payments, the loss of government benefits to them could approach $500 million.22

Tax benefits for personal expenditures may be considered outside the normal structure of the income tax system.23 Under a normal income tax, interest could only be deducted if it were associated with a trade or business or investment property.24 Interest to purchase a personal residence would not be deductible.25 However, deductibility of home mortgage interest has been a feature of the income tax system since its inception.26 Indeed, home ownership is as American as Mom and apple pie, and no politician would dare attack the home mortgage interest deduction.27 In 2005, when President Bush appointed a blue ribbon advisory panel to make recommendations on tax reform, his order specifically noted that the panel should recognize the importance of home ownership to American society.28

II. THE IMPORTANCE OF HOME OWNERSHIP IN LAW AND CULTURE

There’s no place like home.29

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22 Muslim Americans constitute 0.6% of the U.S. population, according to the Pew Muslim American study. PEW RESEARCH CENTER, supra note 11, at 9. Calculation: 0.6% x $72.6 billion = $435,600,000.
23 STAFF OF JOINT COMM. ON TAXATION, supra note 21, at 3.
25 Id. § 163(h)(1).
26 See Roberta F. Mann, The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction, 32 ARIZ. ST. L.J. 1347, 1351–52 (2000) (noting that while all personal and business interest payments were deductible until 1986, as a practical matter, the largest portion of consumer debt has historically been mortgage debt).
27 In a statement about the Tax Reform Act of 1986, Senator Gramm said: "There is no basic principle in tax law that is more supported by the American people than the principle that you ought to be able to deduct interest on your home from your taxes." 132 CONG. REC. 13,581 (1986).
28 The President ordered the panel to produce a report containing revenue neutral options to, inter alia, "[s]hare the burdens and benefits of the tax system in an appropriately fair and progressive manner while recognizing the importance of homeownership and charity in American society." PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, AMERICA NEEDS A BETTER TAX SYSTEM 6 (2005), available at http://govinfo.library.unt.edu/taxreformpanel/04132005.pdf.
The cultural importance of the concept of home is fully reflected in law and literature. Homes fulfill both basic and more advanced physical and psychological needs. Home ownership is said to provide a number of societal benefits. Children who live in owner-occupied homes perform better on academic achievement tests, are more likely to finish high school, and are less likely to become pregnant as teenagers. Home-owners are more politically and socially involved than renters. Home-owners are more satisfied and happier than renters. Neighborhoods with a high proportion of owner-occupied housing tend to have higher property values.

In law, homes are frequently treated more favorably than other types of property. Acts that would be considered criminal or tortious are permitted when committed in defense of one’s home. The maxim “[a] man’s home is his castle” is at the core of the Fourth Amendment to the U.S. Constitution. Current case law applying the Fourth Amendment frequently cites to the “castle doctrine.” Law enforcement may not invade a home without a warrant, not even by remote devices such as thermal imaging.

In some ways, home-owners get better protection from property law than other property owners. The right of a creditor to sell the home of a defaulting borrower


31 See A.H. Maslow, A Theory of Human Motivation, 50 PSYCHOL. REV. 370 (1943) (describing his classic theory of the hierarchy of needs, starting with the basic physiological need of food and the secondary safety needs of shelter and property); see also JULIET B. SCHOR, THE OVERSPENT AMERICAN: UPSCALING, DOWNSHIFTING, AND THE NEW CONSUMER 33 (1998) (noting that housing is the most important symbolic communicator of social class).

32 ROBERT D. DIETZ, THE SOCIAL CONSEQUENCES OF HOMEOWNERSHIP 2 (2003), available at www.newtowncdc.org/pdf/social_consequences_study.pdf. Of course, this does not prove causation, as other factors such as the economic status of the parents may play a greater role. Thanks to Ofer Raban for this observation.

33 Id. at 6–7.

34 Id. at 2. But see ANDREW J. OSWALD, A CONJECTURE ON THE EXPLANATION FOR HIGH UNEMPLOYMENT IN THE INDUSTRIALIZED NATIONS: PART I (1996), available at http://www2.warwick.ac.uk/fac/soc/economics/staff/faculty/oswald/unempap.pdf (correlating high home ownership and high unemployment, and concluding that home ownership causes unhappiness).

35 DIETZ, supra note 32.

36 See, e.g., D. Benjamin Barros, Home as a Legal Concept, 46 SANTA CLARA L. REV. 255, 255 (2006). This favorable treatment is not limited to homes held in fee simple ownership.


40 In Kyllo v. United States, law enforcement officers discovered a marijuana growing operation in a home by using a thermal imaging device. 533 U.S. 27, 35 (2001). The Supreme Court held that the search was unconstitutional, citing the heightened privacy expectations that apply to a person’s home. Id. at 35–36.
is limited in many states and most states protect homestead rights of bankrupt homeowners. Although the Internal Revenue Service (IRS) is authorized to seize a person's home to satisfy a claim for delinquent taxes, the Internal Revenue Code (IRC) protects home-owners by generally exempting the principal residence from levy, and permitting seizure only after written approval by a U.S. District Court.

III. TAX BENEFITS FOR HOME OWNERSHIP

In addition to the protection from levy, the IRC benefits home-owners in four significant ways: (1) by sharing the cost of financing through the home mortgage interest deduction; (2) by subsidizing residence-secured consumer debt via the home equity interest deduction; (3) by facilitating mobility by excluding a portion of capital gain on the sale of a principal residence; and (4) by subsidizing local government benefits (like the public schools) through the property tax deduction. The home mortgage interest deduction allows the deduction of interest on up to $1 million of acquisition indebtedness. Acquisition indebtedness must be secured by the residence and be incurred to acquire, construct, or substantially improve the residence. The home equity interest deduction allows the deduction of interest on up to $100,000 of home equity debt. The exclusion of gain from the sale of a principal residence excludes up to $500,000 of gain realized on the sale for married couples filing a joint return, or up to $250,000 of gain for other taxpayers. The home must be occupied by the taxpayer as a principal residence for at least two out of the last five years. All state and local real property taxes may be deducted, including those on a taxpayer's home. The tax system further benefits home-owners by excluding imputed rental income.

42 See, e.g., CAL. CONST. art. 20, § 1.5 ("The Legislature shall protect, by law, from forced sale a certain portion of the homestead and other property of all heads of families."). Professor Barros argues that some states overprotect the homestead interest by "absolutely prohibiting the foreclosure of a home by creditors." Barros, supra note 36, at 284–85.
44 Id. § 163(h)(3).
45 Id. § 163(h)(3)(C).
46 Id. § 121.
47 Id. § 164. I.R.C. § 36 provides a tax credit for first-time home buyers of ten percent of the purchase price of the residence, up to $8,000. The residence must be purchased before December 1, 2009. I.R.C. § 36 (West Supp. 2008).
49 Id. § 163(h)(3)(B).
50 Id. § 163(h)(3)(C).
51 Id. § 121(b).
52 Id. § 121(a).
53 Id. § 164(a)(1).
54 Imputed income is a non-statutory exclusion from gross income. Imputed income can
Our discussion will focus on the first benefit, the home mortgage interest deduction for acquisition debt. The last two statutory benefits are available to all home-owners, irrespective of whether their homes are encumbered by debt or not, so American Muslims may take full advantage. The home equity interest deduction, currently the only tax-subsidized form of consumer debt, does not relate to the acquisition of a home.\(^5\) Although devout Muslims would not benefit from the home equity debt interest deduction, denial of this deduction does not pose entry barriers to home ownership.

Lack of ability to borrow does pose entry barriers to home ownership. Two-thirds of American homes are encumbered by one or more mortgages.\(^5\) Approximately three-quarters of home purchasers finance the purchase.\(^5\) Approximately two-thirds of owner-occupied housing units are encumbered by debt.\(^5\) The modern home mortgage was made possible by federal legislation enacted during the New Deal in the 1930s.\(^5\) This legislation provided the stability needed by the banking industry to provide long-term loans.\(^6\) However, widespread home ownership required not only favorable loan terms, but also a favorable economy.\(^6\) From 1900 to 1940, less than fifty percent of Americans owned their own homes.\(^6\) After World War II ended, economic prosperity and favorable lending for the first time pushed a majority of Americans into home ownership.\(^6\)


\(^5\) Section 163(h)(3)(C) defines home equity indebtedness as "any indebtedness (other than acquisition indebtedness) secured by a qualified residence." See Pau v. Comm'r, 173 T.C.M. (CCH) 1819 (1997) (finding that home equity indebtedness may not be used to acquire the home).

\(^5\) See U.S. CENSUS BUREAU, * supra* note 16.

\(^5\) See DREW, * supra* note 17.


\(^5\) Canova, * supra* note 59, at 1299.


The “New Economics” of John Maynard Keynes provided the intellectual support for much of New Deal banking policy. Keynes himself concluded that “the rate of interest is not self-adjusting at a level best suited to the social advantage but constantly tends to rise too high, so that a wise Government is concerned to curb it by statute and custom and even by invoking the sanctions of the moral law.” Keynes was almost as concerned about usury as the Qur’an. Recent events in the subprime lending market bear out his concerns. Indeed, many view the overheated housing market of the mid 2000s, spurred by easy lending, as the driver for global economic collapse.

IV. ISLAMIC HOME FINANCING ALTERNATIVES

Although Islamic scholars do not agree on whether all interest is prohibited riba, many Muslims are uncomfortable using traditional mortgage financing. In response, Islamic financial institutions have created several forms of shari’a compliant (halal) financing. Although many of these transactions seem to economically resemble a traditional loan, opinions by Islamic scholars, called fatwas, ensure the religious compliance.

64 JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY 351 (1935). The statutes Keynes refers to are exemplified in usury laws.

65 MAURER, supra note 1. “God has laid His curse on usury... Those that live on usury shall rise up before God like men whom Satan has demented by his touch.”

66 See Edmund L. Andrews, Fed and Regulators Shrugged As the Subprime Crisis Spread, N.Y. TIMES, Dec. 18, 2007, at A1 (“[Government officials] waited until it was too late... to tame the [mortgage] industry’s excesses.”); Paul Krugman, Op-Ed., Blindly Into the Bubble, N.Y. TIMES, Dec. 21, 2007, at A39 (“[T]he explosion of ‘innovative’ home lending that took place in the middle years of this decade was an unmitigated disaster... Reasonable estimates suggest that more than 10 million American families will end up owing more than their homes are worth, and investors will suffer $400 billion or more in losses.”).


68 See Seniawski, supra note 5, at 718–19 (describing four views of riba: (1) the classical view: any increase above the original, nominal capital sum is prohibited riba; (2) the modern view: money and interest are modern concepts outside the scope of the riba prohibition; (3) a hybrid view: maintenance of the real value of capital is permitted, but any excess is riba; and (4) another hybrid view: interest is riba, but use of interest as a temporary measure promotes the greater good and is acceptable).

69 See, e.g., Healy, supra note 18 (discussing the situation of Muslim home-owner Subhan Khan, who was ashamed that he purchased his first house using a conventional mortgage, but recently purchased a new home using an Islamic mortgage alternative); Carolyn Said, A Means to a Home: Islamic Co-ops Create Happy Homecomings, SAN FRAN. CHRON., Nov. 1, 2006, at C1.

propriety of each. The distinguishing feature between a halal financing instrument and one that constitutes riba is whether it can be justified as “trade.” Mohammed was a trader before he became the Prophet, and one of the four major axes of Islamic obligations, mu’amalat, pertains to trade. The free market, and its corollary, profit-making, is the basis of the Islamic economic system. In the next section, I will describe each form of Islamic home financing, and compare it to a conventional mortgage.

A. Murabaha

Murabaha is the most common form of Islamic financing. Used for trade financing as well as home financing, a murabaha resembles an installment sale. After the prospective home buyer has identified the home and negotiated a price, the financial institution purchases the home and then sells it to the home buyer at a marked up price. The markup is the financial institution’s profit, justified by its risk in acquiring the home. In a conventional mortgage, the home buyer borrows money from the financial institution, and uses the money to buy the house. The home buyer promises to pay back the financial institution, with interest representing the time value of borrowing the money. In practice, financial institutions bear little risk in a modern

72 See MAURER, supra note 1, at 24.
73 NOMANI & RAHNEMA, supra note 1, at 56. “Mohammed is reported to have said, ‘Welfare and blessedness is composed of ten parts, nine-tenths of which is attained by trade.’” Id.
74 Id. at 25.
75 Id. at 55–57.
76 Walid S. Hegazy, Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism, 7 CHI. J. INT’L L. 581, 598 (2007) (noting that murabaha represents more than seventy percent of all financial structures used by Islamic financial institutions).
78 Chiu & Newberger, supra note 70, at 9–10.
80 Id.
First, the time between the purchase by the financial institution and the purchase by the home buyer can be as short as a few seconds.\textsuperscript{82} Second, the financial institution may require the home buyer to make an irrevocable promise to purchase the home, thus eliminating cancellation risk.\textsuperscript{83} If the home buyer defaults, the financial institution cannot recover more than the contract price, but it is allowed to charge a cancellation fee.\textsuperscript{84} In contrast, a typical mortgage contract permits the lender to collect any interest due.

\textbf{B. Ijara}

\textit{Ijara}, as used in home financing, is a rent-to-own transaction.\textsuperscript{85} The financial institution owns the home during the lease term and the prospective home buyer pays rent.\textsuperscript{86} Title does not transfer to the prospective home buyer until he exercises the option to purchase.\textsuperscript{87} The financial institution has the obligation to pay taxes on the property, although as a practical matter the lease payments include the taxes.\textsuperscript{88} With conventional mortgage financing, the home buyer has title to the home upon closing, and is liable for property taxes as the owner.\textsuperscript{89} \textit{Ijara} transactions appear to conflict with U.S. banking rules, which prohibit banks from holding title to property securing debt for more than five years.\textsuperscript{90} In 1997, the Office of the Comptroller of the Currency (OCC) issued Interpretive Letter 806, finding that an \textit{ijara} transaction offered by the Bank of Kuwait did not violate the National Bank Act of 1864.\textsuperscript{91} The OCC held that "a narrow view of the statute would elevate form over substance because, in this case, having legal title is largely cosmetic and the actual indicia of ownership are borne
The Interpretive Letter paved the way for *ijara* home financing in the U.S. To qualify under the Interpretive Letter, the *ijara* transaction must meet three specific standards designed to show that the transaction is functionally equivalent to conventional financing:

1) the underwriting standard ... must incur the same risks as that of a conventional loan; 2) the risk incurred by the [financial institution] if a customer defaults on payments must be the same as that of a conventional loan; and 3) the risk from the [financial institution’s] holding of legal title to the property must be the same as that of a [financial institution] providing a conventional loan.  

### C. Musharaka

A *musharaka* transaction resembles a partnership. In the case of a home purchase, both the home buyer and the financial institution would own the home. The diminishing *musharaka* seems to be the most appropriate type of *musharaka* for home purchase: the periodic payments made by the customer are divided into a rental payment and a buyout payment, ultimately resulting in a complete transfer of ownership to the buyer. *Musharaka* seems to be less commonly used for home purchase than *murabaha* or *ijara*, possibly because it is viewed as riskier for the financial institution.

### V. TAX FORM OR TAX SUBSTANCE?

The three Islamic financing transactions described above are economically similar to conventional mortgage financing. Should they receive the same tax treatment? Interest payments under a conventional mortgage may be deducted if the loan was used to acquire and is secured by the taxpayer’s principal residence. One could argue that the economic substance of a *murabaha*, *ijara*, or *musharaka* transaction

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92 Id.
93 Chiu & Newberger, *supra* note 70, at 12. The OCC issued a similar letter covering *murabaha* transactions. O.C.C. Interpretive Letter No. 867 (June 1, 1999), available at http://www.occ.gov/interp/nov99/int867.pdf. The OCC stated that “the risk to [the bank] is that the customer will have insufficient resources to meet its obligations. This is the same risk that [the bank] would have under a conventional real estate financing had [the bank] been forced to foreclose upon the property.” Id.
95 Id.
96 Id.
97 Tacy, *supra* note 5, at 359. The OCC has not issued any interpretive letters with respect to *musharaka* transactions. *Mudaraba*, an even less common method of Islamic finance, will not be discussed here. See Chiu & Newberger, *supra* note 70, at 10, 12.
is the same as that of a conventional mortgage. Many financial transactions that differ in form appear similar in substance. Under the substance-over-form principle, the government may impose tax treatment on a transaction according to its substance and contrary to its form. The substance-over-form principle has been called "the cornerstone of sound taxation." The U.S. government has been successful in recharacterizing many corporate tax shelters according to their economic substance. The taxpayer, who chose the form of the transaction, is bound by the consequences of such form. It is axiomatic that the substance-over-form doctrine is a one-way street, enjoyed only by the government. That axiom may be honored more in the breach than the observance, and courts have applied the substance-over-form doctrine in favor of taxpayers as well as in favor of the government.

The difference between conventional mortgage financing and Islamic mortgage alternatives is driven by religious devotion, not tax avoidance. Nonetheless, they raise the same sort of economic concerns. Although the government has not published any guidance on the specific issue of the deductibility of payments under Islamic mortgage alternatives, the deductibility has been asserted by the press and implied by at least one financial institution. One article flatly stated that a home buyer using an

99 See O.C.C. Interpretive Letter No. 806, supra note 91; O.C.C. Interpretive Letter No. 867, supra note 93; see also Joel S. Newman, Islamic and Jewish Perspectives on Interest, 89 TAX NOTES 1311, 1312 (2000).

100 United States v. Phellis, 257 U.S. 156, 168 (1921).

101 Estate of Weinert v. Comm'r, 294 F.2d 750, 755 (5th Cir. 1961).


103 The Second Circuit wrote: "It would be quite intolerable to pyramid the existing complexities of the tax law by a rule that the tax shall be that resulting from the form of the transaction taxpayers have chosen or from any other form they might have chosen, whichever is less." Television Indus., Inc. v. Comm'r, 284 F.2d 322, 325 (2d Cir. 1960).


106 See Newman, supra note 99.
Islamic financing transaction will receive “the tax advantages of a traditional mortgage because the IRS recognizes these unique programs as a traditional mortgage.” In “FAQs,” University Bank in Michigan responds to a query about income taxes: “As a financial institution, we are only able to show profit on the financing of a home in one fashion. Thus we will issue a 1098-INT which you may choose to use to deduct from your taxes.” Presumably, the home buyer will search his or her conscience about the religious implications of treating the Islamic financing transaction as interest before taking the deduction.

Assuming that the home buyer is able to convince his conscience that there is no religious inconsistency in taking an interest deduction for a payment that he has gone to great lengths to show is not interest, the issue remains whether the government will allow the deduction. Deductions are a matter of “legislative grace.” Taxpayers have no constitutional right to any deduction. A taxpayer is entitled to a deduction only if the statutory language clearly provides the benefit. Section 163(h)(3) permits deduction of qualified residence interest, which includes interest on acquisition indebtedness with respect to any qualified residence of the taxpayer. Acquisition indebtedness is clearly defined as any indebtedness “incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and ... is secured by such residence.” The Supreme Court has defined interest as “compensation for the use or forbearance of money.” Holders of Islamic home financing instruments face a possibly insurmountable barrier to deductibility—their payments are not characterized as interest, as required by the plain language of § 163(h)(3). Amounts charged by a lender for specific services, such as settlement fees, and other expenses incurred in obtaining a mortgage, such as commissions and recording fees, are not considered interest. Under this rationale, amounts paid as rent under an ijara or musharaka contract are not deductible.


*Id.*


*See, e.g.*, Rev. Rul. 67-297, 1967-2 C.B. 87 (finding a loan origination fee paid in connection with acquisition of a home mortgage loan guaranteed by the Veterans Administration (VA) was a charge for services and not interest when the VA permitted such charges in lieu of other charges not expressly allowed (e.g., settlement fee)).

I.R.C. § 262 provides: “Except as otherwise expressly provided in this chapter, no
The fact that banking regulators within the OCC found certain Islamic home financing alternatives to be economically equivalent to mortgages is not dispositive for tax purposes. In *Cottage Savings Ass’n v. Commissioner*, bank regulators found one pool of mortgages held by one savings and loan company to be economically equivalent to another pool of mortgages held by another savings and loan company. Nonetheless, the Supreme Court found the two pools of mortgages represented different legal entitlements and thus were materially different for purposes of determining a loss on the exchange.

The structure of the Islamic financing alternatives may raise other barriers to deductibility, even if the payments are considered interest. The first issue is how to determine what portion of the payment is considered interest. This issue can be resolved under the principles of the original issue discount (OID) rules. The OID rules are designed to apply to certain financing transactions that do not have adequate stated interest. Under these complex rules, deemed or imputed interest may be determined. The tax consequences to the lender and the borrower follow from the calculation of imputed interest: the lender is treated as if it received the deemed interest and the borrower is treated as if he or she paid the interest.

Other issues arise due to the structure of Islamic financing alternatives. Under *murabaha*, *ijara*, or *musharaka* contracts, the home buyer may not receive title to the home for many years. Thus, the IRS could argue (1) the purported home buyers do not own the home and/or (2) the home buyers are not liable on a mortgage. The Tax Court has narrowly construed the availability of the mortgage interest deduction, although the results in the cases vary. Generally, taxpayers may only deduct interest on a loan if they are liable under the loan. Liability does not need to be personal liability. In the case of a recourse loan, the borrower is personally liable, that is, the lender may attach assets other than the home to satisfy the debt. If the loan is non-recourse, the lender may only look to the home securing the debt for satisfaction. The regulations under §163 recognize the economic substance of non-recourse borrowing and allow an interest deduction to a taxpayer who is not personally liable.
on the mortgage, provided that the borrower is the legal or equitable owner of the property. In *Loria v. Commissioner*, the Tax Court denied a home mortgage interest deduction to the taxpayer, who lived in and paid interest on a home which was owned by his brother. However, the Tax Court distinguished *Loria* in *Uslu v. Commissioner*, permitting a deduction when the taxpayers proved that they were the beneficial owners of a home titled in the name of a brother-in-law. The Tax Court found that the taxpayers were liable to and paid interest on a loan to the brother-in-law, although in fact the taxpayers made payments directly to the bank that had loaned the brother-in-law the purchase price.

While taxpayers holding Islamic financing instruments have some arguments for deductibility, the resolution of the issue is not clear. Taxpayers may be liable for penalties as well as interest if they fail to pay all the tax required. The regulations provide that the taxpayer can avoid the penalty if she has substantial authority for the deduction. Substantial authority is an objective standard based on, *inter alia*, statutes, regulations, case law, revenue rulings, and legislative history. Although the regulations do not quantify the substantial authority standard, commentators generally understand the standard to mean a thirty to thirty-five percent likelihood of prevailing on the merits. Doubts about whether the payments qualify as interest, whether the payor owns the home, and whether the payor is liable on the "loan" all lead to significant uncertainty about the tax treatment of these payments.

A taxpayer can also avoid the penalty if he has a reasonable cause for the underpayment and he acted in good faith. Taxpayers usually meet this standard by using a professional tax return preparer. However, a return preparer is subject to penalties unless the position taken on the return is supported by substantial authority (thirty-five

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125 *See id.* Treas. Reg. § 1.163-1(b) states: "Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness." Treas. Reg. § 1.163-1(b) (as amended in 1976).

126 *Loria v. Comm'r., 70 T.C.M. (CCH) 553 (1995); see also Song v. Comm'r., 70 T.C.M. (CCH) 745 (1995).*

127 *Uslu v. Comm'r., 74 T.C.M. (CCH) 1376 (1997).*

128 *Id.*

129 I.R.C. § 6662 imposes a penalty in the case of a substantial understatement of income tax. I.R.C. § 6662 (2006). Substantial understatement means an understatement that exceeds the greater of ten percent of the tax required to be shown on the return or $5,000. *Id.* § 6662(d)(1)(A) (2006). Section 6601 requires the payment of interest on a tax underpayment. *Id.* § 6601.

130 Treas. Reg. § 1.6662-4(d) (as amended in 2003).

131 *Id.* § 1.6662-4(d)(3)(iii).

132 *See, e.g., Burgess J.W. Raby & William Raby, 'Reasonable Basis' vs. Other Tax Opinion Standards, 73 TAX NOTES 1209 (1996).*

133 I.R.C. § 6664(c)(1).

134 *See Richard Schmalbeck & Lawrence Zelenak, Federal Income Taxation 71 n.26 (2d ed. 2007).*
to forty percent likelihood of prevailing on the merits). The return preparer can avoid the penalty if the position is disclosed on the return, thereby giving the IRS a red flag to audit the taxpayer. As a practical matter, deducting payments made under Islamic mortgage alternatives is a risky business. Given the importance of home ownership, is it appropriate to deny deductibility to Muslims who want to live consistently with their religious beliefs?

If the form of these Islamic mortgage alternatives must be followed for tax purposes, users may be subject to increased compliance costs. A musharaka is like a partnership. Partnerships must file information returns. Using an Islamic mortgage alternative could affect other tax benefits from housing. If the resident of the home sells his interest in the home, that may be the sale of a partnership interest and not eligible for the exclusion of gain on the sale of a principal residence. An ijara is like a lease. The sale of a lease may not be eligible for the exclusion of gain on the sale of a principal residence.

If the Muslim home buyer fails to make payments on the instrument, what will the tax consequences be? Muslim home buyers may be in a better tax position than home-owners with conventional mortgages. Amounts received under a loan are not income because there is a corresponding obligation to repay. When the lender relieves the borrower from the obligation to repay, income results unless a statutory exclusion applies. Under the Mortgage Forgiveness Debt Relief Act of 2007, taxpayers may exclude up to $1 million of cancellation of debt income from a mortgage foreclosure. If the Muslim home buyer has not borrowed money, then the cancellation of the deal will not be income. Failure to make payments on a lease results in the cancellation of the lease, but no tax consequences.

One might argue that Islamic mortgage alternatives should be less susceptible to foreclosure than conventional loans. After all, the purpose of Islamic mortgage alternatives is to avoid the prohibition against riba, or usurious interest; however, one leading Islamic finance scholar argues that Islamic mortgage alternatives are inefficient and complex. Professor El-Gamal notes that the perceived legitimacy of an

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137 See supra Part IV.C.
138 Id. § 6031.
139 Id. § 741 (governing the sale of a partnership interest); Id. § 121(a) (permitting the exclusion of up to $500,000 of gain on the sale of a principal residence).
140 See supra Part IV.B.
141 The sale of rights under a lease is treated as capital gain or loss if all the rights under the lease are transferred. See Comm’r. v. P.G. Lake, Inc., 356 U.S. 260, 267 (1958).
144 MAHMoud A. EL-GAMAL, ISLAMIC FINANCE: LAW, ECONOMICS AND PRACTICE 20–21 (2006).
Islamic financing product increases with deviations from the financial structure of its conventional counterpart. These deviations may require the creation of special purpose entities or the addition of superfluous transfers, which increase transaction costs and decrease efficiency. These added modifications "dangerously resemble the 'layering' tools of money launderers and criminal financiers." The more complicated the financial structure, the more difficult it is for regulators to understand and track. Thus, Professor El-Gamal considers Islamic finance to be susceptible to abuse by money launderers and criminal financiers. He believes that modern Islamic finance should permit reasonable interest terms and focus on the substance of Islamic jurisprudence rather than its form.

VI. CONSTITUTIONALITY OF TAX TREATMENT

The U.S. Constitution protects an individual's right to free exercise of religion. Professor Alan Brownstein notes that "[t]he free exercise clause identifies the decision to engage in religious worship as a fundamental liberty right." Islamic law is derived from the Qur'an, the Islamic religious text. Thus, the prohibition against interest in Islamic law is part of the religious tenets of Islam. However, the government can provide benefits generally without violating the rights of those whose religion prohibits their taking advantage of those benefits. There is no equality dimension to the free exercise clause. On the other hand, the Fourteenth Amendment provides for equal protection to all persons under the law. The original core concern of the

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145 Id. at 21.
146 Id.
147 Id. at 23.
148 Id. at 24.
149 Id. at 78. Professor Hamoudi also notes that Islamic financing transactions focus on "rigid formalism," rather than the social justice concerns that embue the Qur’an. Hamoudi, supra note 4, at 94.
150 U.S. CONST. amend. I.
152 NOMANI & RAHNEMA, supra note 1, at 45.
153 See Bowen v. Roy, 476 U.S. 693, 707-08 (1986) ("In the enforcement of a facially neutral and uniformly applicable requirement for the administration of welfare programs reaching many millions of people, the Government is entitled to wide latitude. . . . Absent proof of an intent to discriminate against particular religious beliefs or against religion in general, the Government meets its burden when it demonstrates that a challenged requirement for governmental benefits, neutral and uniform in its application, is a reasonable means of promoting a legitimate public interest.").
154 Brownstein, supra note 151, at 98.
155 U.S. CONST. amend. XIV.
equal protection clause was the disparate treatment of a minority or disfavored class.\(^{156}\) While certain religious groups have faced discrimination as disfavored minorities historically,\(^{157}\) courts have rarely decided cases about disparate impact on religious minorities on equal protection grounds.\(^{158}\)

Federal tax statutes usually withstand constitutional challenges.\(^{159}\) Congress has wide discretion to provide deductions, with the only constitutional limitation that it not act so arbitrarily as to violate the Fifth Amendment.\(^{160}\) To show that a tax statute violates the Fifth Amendment, the taxpayer must explicitly show that "a classification is a hostile and oppressive discrimination against particular persons and classes."\(^{161}\) Congress is not required to subsidize constitutional rights through deductions, but it may selectively subsidize them.\(^{162}\)

The enactment of the Religious Freedom Restoration Act (RFRA)\(^{163}\) has not changed the judicial attitude towards tax statutes.\(^{164}\) The RFRA provides that "[g]overnment shall not substantially burden [the free] exercise of religion even if the burden results from a rule of general applicability," unless the government "demonstrates that application of the burden to the person (1) is in furtherance of a compelling governmental interest; and (2) is the least restrictive means of furthering that compelling governmental interest."\(^{165}\) In each federal court of appeals case reviewing RFRA challenges to the tax laws, the court held the tax laws did not unconstitutionally burden the free-exercise rights of the taxpayers.\(^{166}\) As in the pre-RFRA cases, the government's interest in collecting taxes is considered compelling.\(^{167}\)

Professors Stephen Mazza and Tracy Kaye explored the tax policy concept of horizontal equity as a part of the Constitution's equal protection guarantee.\(^{168}\) Horizontal

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156 Brownstein, *supra* note 151, at 103.
157 *Id.* at 106.
158 *Id.* at 103–04.
161 Madden, 309 U.S. at 88.
equity is the principle that similarly situated persons should be taxed similarly. Devout Muslims who want to purchase homes are arguably similarly situated to other taxpayers who want to purchase homes. Is it a violation of horizontal equity if Muslims may not deduct their payments while taxpayers who adhere to other religions (or no religion) may take the home mortgage interest deduction? Mazza and Kaye conclude that constitutional arguments against tax provisions bear little chance of success, stating that such challenges "are rarely successful primarily because of the willingness of courts to defer to the legislature on tax issues."

A. Public Policy

Even if the failure to provide the home mortgage interest deduction to observant Muslims is not subject to constitutional challenge, it raises public policy concerns. The home mortgage interest deduction is by far the largest federal housing assistance program. At $79.9 billion in 2008, it is more than double the $38.2 billion spent by the Department of Housing and Urban Development (HUD) on housing assistance. Should the government allow such a significant benefit to a religious minority only at the cost of inhibiting their free exercise of religion? As noted above, governmental support of home ownership is justified by the argument that home ownership furthers societal values. Religion also furthers societal values, which justifies the constitutional and judicial protection of the free exercise of religion. Religion (1) serves as an independent source of values; (2) is intrinsically spiritual and thus serves as a counterweight against material self-interest; (3) has a communal dimension that encourages human interaction, and (4) is grounded in tradition, which serves as a counterweight to political pressure.

B. Discrimination

Moreover, Muslims face discrimination in obtaining and retaining rental housing, which makes home ownership even more important. In general, harassment, violence

169 See David Elkins, Horizontal Equity as a Principle of Tax Theory, 24 YALE L. & POL'Y REV. 43, 43 (2006). Of course, the principle of horizontal equity is more honored in the breach than in the observance. As Elkins points out, horizontal equity is frequently violated to further the principle of economic efficiency. Id. at 49.

170 Mazza & Kaye, supra note 168, at 670.

171 For data on tax expenditures for housing, see STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2007–2011, at 27 (Comm. Print 2007). For data on HUD housing programs, see NATIONAL LOW INCOME HOUSING COALITION, FY09 BUDGET CHART FOR SELECTED PROGRAMS (2008), available at www2398.ssldomain.com/nlihc/doc/FY09_BudgetChart.pdf (providing data on HUD housing programs).

172 See supra Part II.

and discriminatory treatment against Muslims have continued to increase since the
terrorist attacks of 9/11. One poll showed that twenty-two percent of the respon-
dents would not want an American Muslim as a neighbor. American Muslims re-
ported thirty-three instances of housing discrimination in 2006, representing 1.34% of
the 2,467 civil rights complaints filed by American Muslims. Harassment and
discrimination against Muslims occurred in the home at about the same frequency as
at the airport. Victims report less than one percent of the actual incidents of hous-
ing discrimination, according to the National Fair Housing Alliance; thus, the actual
incidence of housing discrimination against Muslims is probably much higher.
A spokesman for the Fair Housing Council of Orange County, California, noted that
Muslims do not file many housing complaints, stating, "They're afraid to make com-
plaints out of fear of retaliation." In 2005, seven Muslim families sued an Anaheim,
California, apartment complex alleging religious and housing discrimination. The
apartment manager allegedly yelled at Muslim children and frequently referred to
Muslim tenants using profanity. When a Muslim family circulated a petition seeking
a new manager, they received an eviction notice. A Muslim family in a San
Francisco housing project sued the San Francisco Housing Authority for failing to
protect them from discrimination and for denying an emergency transfer to another
apartment. Neighbors accused them of being terrorists, and someone broke into
their apartment, desecrated their Qur’an, and shredded their traditional clothing.
In 2002, the Los Angeles Times reported that the magazine of the Apartment Owners
Association of Southern California published an article titled, "A Moment of Truth
for Muslims." According to the Times, the article “described Islam as ‘a religion of
violence and hatred,’ and accused Muslims of being ‘responsible for most terrorism
in the world today.’" An Internet advertisement for rental housing included the

174 COUNCIL ON AMERICAN-ISLAMIC RELATIONS (CAIR), THE STATUS OF MUSLIM CIVIL
175 Id. at 6.
176 Id. at 17.
177 Id. at 16.
178 NAT’L FAIR HOUSING ALLIANCE, THE CRISIS OF HOUSING SEGREGATION: 2007 FAIR
HOUSING TRENDS REPORT 3 (2007), available at http://www.nationalfairhousing.org/LinkClick
.aspx?fileticket=F1USduPfzQ0%3D&tabid=2555&mid=5321.
180 Id.
181 Id.
182 Id.
183 Marisa Lagos, Muslim Tenant Sues Housing Authority, SAN FRAN. CHRON., Dec. 10,
2007, at D1.
184 Id.
185 Jocelyn Y. Stewart, Groups Fight Increase in Bias Against Arabs, L.A. TIMES, July 8,
2002, at B3.
186 Id.
statement, "Arabians tend to clash with me so that won’t work out." Discrimination against immigrants is also on the rise, fostered in part by restrictive state legislation. Of course, purchasing a home is no guarantee that a Muslim family will be welcomed in the neighborhood. It does, however, eliminate the risk of eviction.

VII. SOLUTIONS

A. Administrative Guidance

Possible solutions to the problem of non-deductibility of payments under Islamic mortgage alternatives range from targeted relief to sweeping changes to the structure of the income tax. Muslim home buyers could each seek a private letter ruling on the tax consequences of their transactions from the IRS. Although it may seem more efficient to have the Islamic financial institution seek a private letter ruling with respect to each instrument they offer, the issue is whether the payments are deductible by the customer. Thus, the private letter ruling would have to be issued to each customer. This could impose an undue burden on the IRS. Letter rulings are not precedent, so home buyers could not rely on letter rulings issued to other home buyers. Private letter rulings cannot be obtained without a fee, which will add to

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187 NAT'L FAIR HOUSING ALLIANCE, supra note 178, at 24.
188 Id. at 19.
189 A [private] "letter ruling" is a written determination issued to a taxpayer by an Associate Office [or the IRS] in response to the taxpayer's written inquiry, filed prior to the filing of returns or reports that are required by the tax laws, about its status for tax purposes or the tax effects of its acts or transactions. A letter ruling interprets the tax laws and applies them to the taxpayer's specific set of facts. Rev. Proc. 2008-1, 2008-1 I.R.B. 6.
190 The Service ordinarily does not issue letter rulings or determination letters regarding the tax consequences of a transaction for taxpayers who are not directly involved in the request if the requested letter ruling or determination letter would not address the tax status, liability, or reporting obligations of the requester. For example, a taxpayer may not request a letter ruling relating to the tax consequences of a transaction to a customer or client, if the tax status, liability or reporting obligations of the taxpayer would not be addressed in the ruling, because the customer or client is not directly involved in the letter ruling request.
191 Id. at 14.
192 In Part I, I estimated that over 500,000 home buyers might seek Islamic mortgage alternatives. According to a LEXIS/NEXIS search, the IRS issued 1,950 letter rulings from January 1, 2006 until December 31, 2006. It seems unlikely that the IRS would have adequate resources to provide guidance in private letter ruling form to that many taxpayers.
the costs of each home buyer. The IRS has discretion as to whether to issue a private letter ruling, so the home buyers are not assured of receiving relief. Professor Newman opined that the IRS will probably remain silent on the issue of Islamic home financing transactions.

A more efficient alternative for the IRS would be to write one or more revenue rulings detailing the tax consequences of particular Islamic financing alternatives. A revenue ruling is "an official interpretation by the Service that has been published in the Internal Revenue Bulletin." Revenue rulings are IRS interpretations of substantive law as it pertains to a particular fact pattern. Revenue rulings may be used as precedent, but they do not have the force of law. Rather, they are a statement of the IRS's position. A court is free to accept or reject a position set forth in a revenue ruling on the basis of its evaluation of such factors as "the degree of the agency's care, its consistency, formality, and relative expertness, and . . . the persuasiveness of the agency's position." However, courts will generally enforce a taxpayer's reliance on an IRS revenue ruling if the facts are sufficiently similar.

Revenue rulings typically contain an issue statement, recitation of the factual situation, statement of applicable law, analysis of the law, and the holding. The IRS could write a revenue ruling stating that payments under an ijara transaction would be eligible for the home mortgage interest deduction because the payments represent interest in substance. Taxpayers with ijara transactions could rely on the revenue ruling, but taxpayers using a musharaka transaction would probably not be able to rely on the revenue ruling. In 1983, the IRS wrote a revenue ruling considering an alternative mortgage transaction called a shared appreciation mortgage (SAM).

193 The fee for letter ruling request involving a personal or business issue is $625 if the requestor has a gross income of less than $250,000. For requestors with gross income between $250,000 and $1 million, the fee is $2,100. If the requestor's gross income is more than $1 million, the fee is $11,500. Rev. Proc. 2008-1, 2008-1 I.R.B. 67, 67-68 (Appx. A).
194 "[T]he Service may decline to issue a letter ruling or a determination letter when appropriate in the interest of sound tax administration or on other grounds whenever warranted by the facts or circumstances of a particular case." Id. at 14.
195 "If I were with the IRS, I would prefer not to know too much about these religiously inspired transactions." Newman, supra note 99, at 1318.
197 "[C]onclusions expressed in Revenue Rulings will be directly responsive to and limited in scope by the pivotal facts stated in the revenue ruling." Id. § 601.601(d)(2)(v)(a).
198 Id. § 601.601(d)(2)(v)(d).
202 Id.
The purpose of the SAM transaction was to enable home buyers to acquire mortgages with affordable payments during a time of historically high interest rates. The SAM agreement, the borrower agrees to execute a mortgage for the principal amount and pay fixed interest at a certain rate plus "contingent" interest. The contingent interest is equal to a percentage of the appreciation of the value of the residence over the term of the SAM. The IRS held that the contingent interest, even though calculated with reference to the appreciation in value of the principal residence, was nonetheless deductible. The IRS limited the application of the revenue ruling with the following caveats:

The conclusions of this revenue ruling are limited to the fact situations set forth above. Accordingly, such conclusions should not be considered to apply to SAM agreements, particularly in situations in which the loan proceeds are used for commercial or business activities, in which the lender acquires greater rights with respect to the borrower or the mortgaged property than are described in the facts section of this ruling; in which the parties evidence an intention to create a relationship other than that of debtor and creditor; or if other circumstances indicate that the SAM loan represents in substance an equity interest in the mortgaged property. In addition, the ruling should not be considered to apply where the borrower under the SAM is a corporation.

The revenue ruling could be viewed as applying a substance-over-form analysis to the issue of whether a payment represented interest. Under such an analysis, Islamic mortgage alternatives have many of the indicia of debt. This issue most frequently arises in the context of corporate financing, and courts have identified a number of criteria by which to determine whether an instrument is debt:

(1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the "thinness" of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest

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203 Id.
204 Id.
205 Id.
206 Id. at 49.
207 Id.
and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.

In an Islamic home financing transaction, the financial institution, like a traditional mortgagor, has very little risk. The home-owner "manages" the residence, not the financial institution. The home-owner generally makes fixed payments.

As each Islamic financing transaction may have subtle differences, drafting a revenue ruling of general applicability could be difficult. A potential solution could be to issue a number of "safe harbor" revenue rulings, detailing the transactional elements that must be present to qualify for the home mortgage interest deduction. The IRS could issue one ruling that applied to ijara transactions, another that applied to musharaka transactions, and so on. However, as each bank that provides Islamic financing relies on a fatwa by a particular scholar, the fatwas may be sufficiently different to raise the question of whether a revenue ruling of general applicability covers the transaction. A similar situation arose in the 1980s and 1990s with respect to the tax classification of limited liability companies. Before the state law development of limited liability companies, business entities could take one of three different forms: corporation, partnership or sole proprietorship. The corporate form was the only form that provided for limited liability for all owners. Limited partnerships were available, but state law required at least one general partner, which would be subject to all the liability of the business. Corporations enjoyed limited liability but then, as now, were subject to double taxation. Income earned by a corporation was subject to tax at the corporate level, and when the income was distributed to investors, they would also pay a tax on the distribution. Wyoming was the first state to enact a limited liability company statute. The tax issue was whether to treat this new type of entity as a corporation for tax purposes or as a partnership. Under then-current regulations, the determination was made using a facts and circumstances approach.

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208 Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968).
209 See O.C.C. Interpretive Letter No. 806, supra note 91.
211 Id. at 1505.
entity had a majority of "corporate" factors, it would be classified as a corporation.\textsuperscript{214} If not, it would be a partnership if it had two or more owners. Otherwise, it would be ignored for tax purposes. One by one, each state enacted limited liability company statutes.\textsuperscript{215} The IRS began analyzing each state statute and drafting revenue rulings.\textsuperscript{216} In the meantime, Congress passed the Tax Reform Act of 1986, for the first time dropping individual tax rates significantly below corporate tax rates.\textsuperscript{217} Suddenly, it was no longer advantageous from a tax perspective to operate in corporate form. But the regulations were drafted to make corporate tax treatment harder to get.\textsuperscript{218} After many revenue rulings and proposals, the Treasury Department issued the "check-the-box" regulations, allowing taxpayers to choose the tax form of their business entities.\textsuperscript{219} The "check-the-box" regulations have been lauded as models of clarity in tax administration.\textsuperscript{220} Overnight, the IRS was out of the business of classifying entities based on a facts-and-circumstances determination.

If the IRS issued a revenue ruling on an Islamic home financing transaction, requests for additional guidance may follow. As seen above in the discussion of business entities, if a critical mass of inquiries develops, pressure may build for regulatory guidance. The basic issue is much broader than determining the tax consequences of an Islamic home financing transaction. The basic issue is what is debt.\textsuperscript{221} In the case

\begin{itemize}
\item \textsuperscript{214} Id. The four corporate factors were: (1) continuity of life; (2) centralized management; (3) limited liability; and (4) free transferability of interest. The regulations were based on \textit{United States v. Kintner}, 216 F.2d 418 (9th Cir. 1954), and applied principles derived from \textit{Morrissey v. Comm'r.}, 296 U.S. 344 (1935) (defining "association" for tax purposes).
\item \textsuperscript{215} All fifty states and the District of Columbia have LLC statutes. Hawaii was the last state to enact an LLC statute. \textit{See} 1996 \textit{Haw. Sess. Laws} 181 (enacted June 7, 1996) (codified at \textit{Haw. Rev. Stat.} § 428-101 to 428-1302 (Supp. 2007)).
\item \textsuperscript{217} \textit{See Hamill}, \textit{supra} note 210, at 1517.
\item \textsuperscript{218} \textit{Larson v. Comm'r.}, 66 T.C. 159, 187 (1966) (Dawson, J., concurring) ("[T]he regulations were weighted against qualification for corporate status.").
\item \textsuperscript{219} \textit{Treas. Reg.} § 301.7701-1 (as amended 2009).
\item \textsuperscript{220} Jack R. Skinner, Letter to the Editor, \textit{TEI Endorses Check-the-Box}, 71 \textit{Tax Notes} 263, 263 (1996) ("[T]he check-the-box procedure brings much-needed clarity and simplicity."). \textit{But see} Heather M. Field, \textit{Checking in on "Check-the-Box"} (forthcoming 2009) ("[T]he CTB regulations are far from a panacea for all that ailed the entity classification process . . . ."). \textit{Available at} \textit{http://papers.ssm.com/sol3/papers.cfm?abstract_id=1161318.}
\item \textsuperscript{221} One author has used Islamic mortgage alternatives as an example of ancient arbitrage, highlighting the structures as a precursor to modern financial instruments. \textit{See} Michael S. Knoll, \textit{The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage}, 87 \textit{Or. L. Rev.} 93, 101–07 (2008).
\end{itemize}
of a corporate debt versus equity inquiry, there can be a lot of dollars at stake. The corporation may not deduct dividends paid to investors, while interest paid to lenders is deductible.\(^{222}\) For financial accounting purposes, equity financing is preferred over debt financing. The holy grail for corporate financing is to find an instrument that looks like equity for financial accounting purposes but looks like debt for tax purposes.\(^{222}\) Congress and the Treasury Department have tackled this issue, but without success. In 1969, Congress enacted I.R.C. § 385, which authorized the Treasury Department to issue regulations as “necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness.”\(^{224}\) The Treasury Department duly issued regulations in 1980, which were revised in 1981 and 1982, and withdrawn in 1983, amid general consensus that they would not work.\(^{225}\) The regulations took a facts and circumstances approach.\(^{226}\)

If the Treasury Department were to take a “check-the-box” approach to debt or equity classification regulations, that could provide many of the same benefits provided by the “check-the-box” entity classification regulations. In addition to solving the Islamic home financing tax issue, it could solve many perplexing problems in the tax shelter area as well.\(^{227}\) But that is a discussion well beyond the scope of this Article.\(^{228}\) The point of this digression is that although this discussion of revenue rulings started as a narrow relief proposal, it could lead to one of the most sweeping changes in the tax law in modern history. With that perspective, we can see that the next proposal, remodeling the home mortgage interest deduction, is modest and conservative.


\(^{226}\) Keinan, *supra* note 225, at 702 n.127.

\(^{227}\) See I.R.S. Notice 94-47, 1994-1 C.B. 357 (describing a hybrid financial instrument known as MIPS (monthly income preferred securities)); see also Frank Lyon Co. v. United States, 435 U.S. 561 (1978) (ruling in favor of the taxpayer, despite the IRS arguing that a sale-leaseback transaction created debt); Rice’s Toyota World, Inc. v. Comm’r., 752 F.2d 89 (4th Cir. 1985) (holding in favor of IRS’s argument that a transaction formally structured as a sale-leaseback was a debt).

B. The Statutory Solution: Remodeling the Home Mortgage Interest Deduction

The discriminatory effect of the home mortgage interest deduction is only one reason why it should be remodeled.\textsuperscript{229} Under classic tax policy criteria, tax provisions should be fair, efficient, and simple. The home mortgage interest deduction is neither fair nor efficient. Obviously, the home mortgage interest deduction does not help observant Muslims become home-owners. It also doesn’t help home-owners who don’t itemize deductions,\textsuperscript{230} home-owners who don’t have mortgages,\textsuperscript{231} and people who can’t afford homes. In fact, the home mortgage interest deduction makes homeownership more costly. Economists have shown that repealing the home mortgage interest deduction would reduce the price of owner-occupied housing, because the effect of the government subsidy is to increase housing prices.\textsuperscript{232} Like any deduction, the home mortgage interest deduction is an upside-down subsidy, benefiting taxpayers in higher income brackets more than taxpayers in lower income brackets.\textsuperscript{233} In 2005, 81.9% of the benefit of this deduction flowed to the top quintile of taxpayers.\textsuperscript{234} The

\textsuperscript{229} The home mortgage interest deduction does not only discriminate against Muslims; it systematically discriminates against minorities. See Beverly I. Moran & William Whitford, \textit{A Black Critique of the Internal Revenue Code}, 1996 WISC. L. REV. 751, 774–75; see also Mann, \textit{supra} note 26, at 1365.


\textsuperscript{231} Over twenty-three million home-owners own their homes free of debt, which represents roughly one-third of all home-owners. U.S. Census Bureau, S2507: Financial Characteristics for Housing Units Without a Mortgage, 2005 American Community Survey, http://factfinder.census.gov/servlet/ACSSAFFHousing?_sse=on&_submenuId=hooding_2 (follow “Financial Characteristics of Units without a Mortgage” hyperlink) (last visited Apr. 17, 2009).


\textsuperscript{233} Because deductions reduce taxable income, the value of a deduction is the amount of the deduction times the taxpayer’s marginal tax rate. For example, a single taxpayer with a taxable income of $22,000 is in the fifteen percent marginal tax bracket. I.R.C. § 1(c) (2006). A $1,000 home mortgage interest deduction would reduce his taxable income by $1,000, thus reducing his tax liability by $150. A single taxpayer with a taxable income of $225,000 is in the thirty-five percent tax bracket. Id. A $1,000 deduction would reduce her taxable income by $1,000, thus reducing her tax liability by $350. President Obama proposes to limit the tax rate at which higher income taxpayers can take itemized deductions, including the home mortgage interest deduction, to twenty-eight percent. OFFICE OF MANAGEMENT AND BUDGET, A NEW ERA OF RESPONSIBILITY: RENEWING AMERICA’S PROMISE 29 (Feb. 26, 2009). If that proposal becomes law, the taxpayer in the thirty-five percent bracket would have her tax liability reduced by $280. See also Laura Meckler, $318 Billion Tax Hit Proposed: Upper-Income Americans Would See Deductions Cut on Charity and Mortgage Interest, WALL ST. J., Feb. 26, 2009, at A1.

\textsuperscript{234} ADAM CARASSO, C. EUGENE STEUERLE & ELIZABETH BELL, URBAN INSTITUTE, MAKING TAX INCENTIVES FOR HOMEOWNERSHIP MORE EQUITABLE AND EFFICIENT 29 tbl.2 (2005),
top quintile includes taxpayers with a cash income of $78,646 or more. Only 3.5% of the benefit flowed to taxpayers below the fourth quintile, which includes taxpayers with a cash income less than $44,601.

The home mortgage interest deduction is inefficient because it leads to over-investment in housing. The President’s Advisory Panel on Tax Reform compared the effective tax rates on various types of investments:

- Owner-occupied housing 0%
- Non-corporate business 17%
- Corporate business 26%
- Overall business sector 22%
- Overall economy 14%

Economists concluded that such different effective tax rates must lead to a distortion in investment. Any tax incentive that targets housing will have some distorting effect. However, addressing the fairness issue will also reduce the efficiency concerns. If the federal housing tax benefit more narrowly targets actual housing needs, it will stop encouraging excess investment in housing. A recent report by the Congressional Research Service (CRS) notes that the home mortgage interest deduction subsidizes mortgage rates, which have a larger effect on housing consumption than on home ownership rates.

The home mortgage interest deduction applies only to housing acquired with debt, and only to the interest on that debt. Excessive debt leads to misery and chasing the American dream has lured increasing numbers of Americans into too large mortgages. The Joint Center for Housing Studies reports that over just two years, interest-only


235 Id.
236 Id.
237 President’s Advisory Panel of Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System 71 (2005).
238 John E. Anderson, Jeffrey P. Clemens & Andrew R. Hanson, Tax Reform and Incentives to Encourage Owner-Occupied Housing: Analysis of the President’s Tax Reform Panel Recommendation to Convert the Mortgage Interest Deduction to a Tax Credit 5 (Sept. 19, 2006) (unpublished manuscript, available at http://ssrn.com/abstract=943062). The zero tax rate on owner-occupied housing also reflects the deduction for property taxes, the exclusion of gain on the sale of a principal residence, and, most significantly, the exclusion of imputed rental income.

240 Charles Dickens said it better: “Annual income twenty pounds, annual expenditure nineteen nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.” Charles Dickens, David Copperfield 184 (Thomas Nelson and Sons 1906) (1850).
loans rose to 20% of the dollar value of all loans and 37% of adjustable rate loans in 2005.241 Subprime loans, made to borrowers with weaker credit, increased from 2.4% in 1998 to 13.6% of loans made in the third quarter of 2006.242 More than 19% of subprime loans made in 2005 and 2006 are at risk for foreclosure.243 The link between the home mortgage interest deduction and debt is a historical artifact. The home mortgage interest deduction was created in 1986 when Congress repealed the deductibility of interest paid on personal debt. Why should a tax benefit to encourage home ownership be based on debt?244

CONCLUSION

Remodeling the home mortgage interest deduction would be the most effective and efficient way of solving the problem of the Islamic financing tax dilemma. The dilemma should be solved because although there is no constitutional right to a deduction and generally applied tax provisions have never been held to restrict religious freedom, the significance of the government benefit provided by the deduction and the seriousness of the discrimination faced by Muslim-Americans raises public policy concerns. Moreover, the home mortgage interest deduction is deeply flawed as a policy tool. The President’s Advisory Panel suggested replacing the home mortgage interest deduction with fifteen percent tax credit.245 The tax credit would be based on mortgage payments on loan amounts subject to regional caps related to median house prices.246 A group of tax scholars recently concluded “it is likely that some type of refundable credit is always the efficient form for a tax incentive.”247 President Obama proposes to limit high-income taxpayers’ benefits from the home mortgage interest deduction.248 High-income taxpayers could still take the deduction, but it would reduce their tax liability as if their marginal rate was twenty-eight percent.249 Professor Kirk Stark suggests that the President’s proposal is “a step in the direction

243 Id. (citing the Center for Responsible Lending).
244 However, the recent CRS report noted that reducing the amount required for a down payment increased the probability of home ownership by 4.5 percentage points for all households, with an even greater rise for minority households. Jackson, supra note 239, at 12.
245 See PRESIDENT’S ADVISORY PANEL, supra note 237, at xvii.
246 Id.
248 See OFFICE OF MANAGEMENT AND BUDGET, supra note 233.
249 Id.
of converting these subsidies to credits." The CRS report noted that a tax credit could have the effect of lowering the price of lower priced homes, thus increasing home ownership.

The credit would not have to be based on interest paid. It could be based on a percentage of the cost or value of the home. Eliminating the debt component of the housing tax benefit would have the salutary effect of taking the government out of the housing debt subsidy business, and have the additional benefit of permitting a deduction for payments made under an Islamic home financing arrangement.

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250 Posting of Kirk Stark, STARK@law.ucla.edu, to Taxprof@listserv.uc.edu (Feb. 26, 2009) (on file with author).