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The Home Mortgage Interest Deduction Limitation – Recent Developments

2321 N. Loop Drive, Ste 200 • Ames, Iowa 50010 www.calt.iastate.edu

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- by Roger A. McEowen

Overview

In general, interest is not deductible. But, a major exception to the rule of non-deductibility exists for "qualified residence interest" – that's interest that is paid or accrued during the tax year on "acquisition indebtedness" or "home equity indebtedness" for any "qualified residence" of the taxpayer.[1] Interest deductibility is limited to the first $1,000,000 of acquisition debt ($500,000 for married persons that file separately)[2] and $100,000 of qualifying home equity indebtedness.

It has been the general view that the $1,000,000 cap is a limit on both types of indebtedness in a single loan.[3] But, in late 2009 IRS said that a taxpayer can treat up to $100,000 in excess of the $1,000,000 limit as "home equity indebtedness" for deduction purposes.[4] "Now, IRS has reiterated its position in a Revenue Ruling.[5]

What Is Acquisition Indebtedness and Home Equity Indebtedness?

The Code defines "acquisition indebtedness" as the following:

- Debt that is incurred in acquiring, constructing or substantially improving the taxpayer's qualified residence and is secured by the residence;[6]
- Qualified indebtedness that is refinanced (to the extent the debt resulting from the refinancing does not
- exceed the original refinanced debt);[7] and
- Premiums paid for qualified mortgage insurance by a taxpayer in connection with acquisition indebtedness on a qualified residence of the taxpayer.[8]

Under the Code, "home equity indebtedness" means:

- Debt, other than acquisition indebtedness, which the qualified residence secures and is an amount that does not exceed the fair market value of the residence reduced by the acquisition debt on the property.[9]

Importantly, the definition of "home equity indebtedness" specifically *excludes* any debt that is treated as acquisition indebtedness.[10]

> **Note:** The statutory definitions of both "acquisition indebtedness" "home equity indebtedness" require that the debt secure the residence.

What Is A "Qualified Residence"

A "qualified residence" is the taxpayer's principal residence and one other "dwelling" the taxpayer uses as a residence during the year."[11] Thus, interest is deductible, for example, on a

mortgage secured by a taxpayer's principal residence and a vacation home that a taxpayer uses as a personal residence for personal purposes for a period exceeding the greater of 14 days or 10 percent of the number of days during the year that the property is rented at fair rental.[12] If a dwelling is not rented at any time during the tax year, it meets the definition of a "residence."[13] In addition, a "residence" can generally include a house, condominium, mobile home, boat, or house trailer that contains sleeping space and toilet and cooking facilities.[14]

Amount Deductible – How Are "Acquisition Indebtedness" and "Home Equity Indebtedness" To Be Defined?

Clearly, taxpayers can deduct interest on $1,000,000 of acquisition debt *and* an additional $100,000 of home equity debt. But, is that $1,100,000 deductible on a single loan on a residence? That's an important question to taxpayers with a substantial amount of principal residence indebtedness, with the answer depending on the interpretation of the definitions of "acquisition indebtedness" and "home equity indebtedness."

The Tax Court's view. The Tax Court, in *Pau v. Com'r.*,[15] limited the deduction to interest on $1,000,000 of qualified indebtedness. The case involved taxpayers that incurred a $1.3 million mortgage on a principal residence. They wanted to treat $1 million as acquisition indebtedness and $100,000 as home equity indebtedness, but the Tax Court didn't allow it because the taxpayers couldn't prove that any portion of the debt was anything other than acquisition indebtedness. The Tax Court has also reached the same result in a subsequent case.[16]

The IRS view. In Publication 936 and in a 1988 Notice[17] said that a single indebtedness can qualify partially as acquisition debt and partially as home equity debt.[18] But, IRS has also taken the position that interest on any portion of a home acquisition loan (or loans) over $1,000,000 is non-deductible.[19]

IRS has now looked at the issue again. In late 2009, IRS initially noted that the $1,000,000 limitation could be read as either an outright limit on the total amount deductible or as part of the definition of "acquisition indebtedness."[20] IRS made an interesting point that if the $1,000,000 amount truly is a limit on the amount that is deductible, then no debt that is indebtedness that is incurred for a qualifying use and is secured by the residence would qualify to be deducted as home equity debt - it would be acquisition debt. But, IRS also pointed out that if the $1,000,000 limitation is contained within the definition of acquisition indebtedness, then any amount exceeding $1,000,000 would *not* be acquisition indebtedness and, thus, would qualify as home equity indebtedness. Ultimately, IRS concluded that analysis was insufficient to determine the issue, so they examined how the phrase "acquisition indebtedness" was used elsewhere in the Code.

IRS looked at two other Code provisions for guidance on the issue. IRS first noted that I.R.C. §108(h)(2) (concerning qualified mortgage debt relief) presumes that the $1,000,000 amount is contained within the definition of "acquisition indebtedness," and is not merely a limitation. Thus, IRS reasoned, if "acquisition indebtedness" meant *all* debt used to acquire, construct or substantially improve a qualified residence, the Congress would not have had to modify the definition of acquisition indebtedness contained in I.R.C. §108(h)(2). Instead, IRS reasoned, it would have been enough for the Congress to state that "acquisition indebtedness" is eligible for exclusion. IRS also noted that I.R.C. §56(e) (concerning the alternative minimum tax (AMT)) contains a definition of AMT-deductible "qualified housing interest."[21] There it is defined as "qualified residence interest" under I.R.C. §163(h)(3) (meaning *both* acquisition indebtedness and home equity indebtedness) that is incurred in acquiring, constructing or substantially improving the property.[22] Thus, IRS reasoned, if the $1,000,000 amount were not contained within the definition of acquisition indebtedness, then deductible interest on acquisition indebtedness

under I.R.C. §56(b)(1)(C) for AMT purposes would be unlimited. IRS didn't believe the Congress intended that result. Thus, IRS concluded, the $1,000,000 limit must be part of the definition of "acquisition indebtedness." As a result, interest on an additional $100,000 of qualifying debt is deductible as home equity debt – in a single loan.

In Rev. Rul. 2010-25[23], the taxpayer (unmarried person) bought a principal residence for $1,500,000 (the home's fair market value). The taxpayer put $300,000 down and took out a mortgage of $1,200,000. For the tax year, the taxpayer paid interest on the mortgage. The IRS said that the taxpayer could deduct, as interest on acquisition indebtedness under I.R.C. §163(h)(3)(B), interest paid during the year on $1,000,000 of the $1,200,000 indebtedness that was used to acquire the principal residence. As for the additional $200,000 of debt that the taxpayer incurred, IRS ruled that the taxpayer could also deduct as interest on home equity indebtedness (by virtue of I.R.C. §163 (h)(3)(C), interest paid during the tax year on $100,000 of that additional $200,000 of debt. IRS noted that the $200,000 was secured by the residence, was not acquisition debt and did not exceed the fair market value of the residence reduced by the acquisition debt secured by the residence."

Application of the Limitation

As noted above, interest deductibility is limited to the first $1,000,000 of acquisition debt ($500,000 for married persons filing separately)[24] and $100,000 of qualifying home equity indebtedness. The limitation applies on a *per-mortgage basis*, rather than on a per-taxpayer basis. So, for multi-million dollar homes that are co-owned by unmarried persons, interest is deductible only on $1 million of acquisition indebtedness, not the interest attributable (at the maximum) to a single $2 million mortgage (attributed due to ownership equally between the co-owners).[25] The U.S. Tax Court reiterated this point in *Sophy v. Comr.*[26]

Conclusion

The IRS position taken in ILM 200940030 is contrary to the Tax Court opinions in *Pau*[27] and *Catalano,*[28] but it does indicate the current litigating position of IRS on the issue. That could be helpful to taxpayer's with significant principal residence indebtedness that have claimed an interest deduction on up to $1,100,000 of principal residence debt without being challenged by IRS – IRS apparently won't challenge that position now. For taxpayers currently under examination on the issue, ILM 200940030 raises the question as to whether IRS will drop the issue and allow the additional interest deduction. The IRS position could also be of assistance to taxpayers that have a significant amount of principal residence indebtedness and AMT liability.[29] In any event, the IRS guidance is a helpful clarification.

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[1] I.R.C. §163(h)(3)(A)(i)-(ii). The determination of whether any property is a qualified residence of the taxpayer is made as of the time the interest is accrued.
[2] I.R.C. §163(h)(3)(B)(ii).
[3] *See, e.g.*, Pau v. Comr., T.C. Memo. 1997-43; Catalano v. Comr., T.C. Memo. 2000-82; IRS Pub. 936.
[4] ILM 200940030 (Aug. 7, 2009).
[5] Rev. Rul. 2010-25, 2010 I.R.B. LEXIS 714.
[6] I.R.C. §163(h)(3)(B)(i)(I-II). The statute does not define "substantially improving."
[7] I.R.C. §163(h)(3)(B)(i)(II).
[8] I.R.C. §163(h)(3)(E)(i). The provision applies to amounts paid or accrued after December 31, 2006, but only with respect to contracts entered into after December 31, 2006, and for premiums paid before January 1, 2010. The deduction is phased-out ratably by 10 percent for each $1,000 by which the taxpayer's adjusted gross income exceeds $100,000. I.R.C. §163(h)(3)(E)(ii). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds $110,000. "Qualified mortgage insurance" means mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, the Rural Housing Administration, and private mortgage insurance (as defined in Section 2 of the Homeowners Protection Act of 1998). I.R.C. §163(h)(4)(E).
[9] I.R.C. §163(h)(3)(C).
[10] I.R.C. 163(h)(3)(C)(i).

[11] I.R.C. §163(h)(4)(A)(i). Taxpayers that own more than two "residences" can select the two residences with the most annual mortgage interest. In many instances that will be the taxpayer's primary residence and the taxpayer's vacation home (or the vacation home (if the taxpayer owns more than one) with the largest indebtedness).
[12] I.R.C. §§163(h)(4)(A)(i)(II); 280A(d)(1). For purposes of this provision, personal use includes use by family members and anyone else who pays less than market rental rates.
[13] Treas. Reg. §1.163-10T(p)(3)(iii).
[14] Treas. Reg. §1.163-10T(p)(3)(ii).
[15] Pau v. Comr., T.C. Memo. 1997-43.
[16] Catalano v. Comr., T.C. Memo. 2000-82 (IRS permitted to raise the I.R.C. §163(h) limitation for first time in post-trial brief; I.R.C. §163 is an express statutory limitation that is mechanically applied and no facts were in dispute).
[17] IRS Notice 88-74, 1988-2 C.B. 385.
[18] In the Notice, IRS used an example of a single indebtedness that was secured by a qualified residence which was partially used for other purposes. IRS said that the portion of the debt that qualified for acquisition indebtedness treatment would be treated as acquisition indebtedness, and the balance as home equity indebtedness, subject to the $100,000 limitation.
[19] FSA 200137033 (Jun. 18, 2001), following the Tax Court's position taken in *Pau v. Comr., T.C. Memo. 1997-43*.
[20] ILM 200940030 (Aug. 7, 2009).
[21] See I.R.C. §56(b).
[22] I.R.C. §163(h)(3).
[23] 2010 I.R.B. LEXIS 714.
[24] I.R.C. §163(h)(3)(B)(ii).
[25] ILM 200911007 (Nov. 24, 2008).
[26] 138 T.C. No. 8 (2012)(case involved homosexual co-owners, but court's holding equally applicable to any unmarried couple).
[27] Pau v. Comr., T.C. Memo. 1997-43.
[28] Catalano v. Comr., T.C. Memo. 2000-82.
[29] The AMT issue could become of greater significance if the Congress fails to "patch" or reform the AMT.