IRS ADJUSTS STANCE ON HOME EQUITY DEBT

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Taxpayers will benefit from the Service's change of position about deducting acquisition costs as home equity debt.

In 1987, Congress amended Section 163(h)(3) (which had been enacted the prior year), establishing the qualified residence interest rules. Under these rules, there is a limitation of $1,000,000 ($500,000 for married individuals filing separately) on acquisition indebtedness[1] and a limitation of $100,000 ($50,000 for married individuals filing separate) on home equity indebtedness.[2] One facet of the relationship between those two limitations was not spelled out in the Code: Can a mortgage incurred to acquire a residence include a home equity indebtedness portion?[3]

The Tax Court determined that it could not.[4] In FSA 200137033, the Service came to the same conclusion as the Tax Court. More recently however, the IRS changed its mind and answered affirmatively.[5] This article will discuss the Tax Court decisions and the reasoning of the Field Service Advice. The article will then explain the Service's change in interpretation.

Debt incurred to acquire residence cannot be deducted as home equity indebtedness

In *Pau*, the taxpayers purchased a principal residence for $1,780,000 in 1989. The original amount of the mortgage was $1,330,000. On their 1990 return, the taxpayers limited their deduction for mortgage interest to interest on a $1.1 million mortgage. The IRS eventually allowed the taxpayers a deduction of interest on a $1 million mortgage.

The Tax Court pointed out that Section 163(h) limits the home mortgage interest deduction to interest on $1 million of acquisition indebtedness incurred after 10/13/87. In addition, taxpayers are allowed an additional interest deduction for interest on home equity indebtedness of up to $100,000. Home equity indebtedness is defined as "any indebtedness (*other than acquisition indebtedness*) secured by a principal residence."

The taxpayers were unable to prove that any of the debt was not used to acquire their house. However, Section 163(h)(3)(C) appears to require that on its face. Therefore, the Service's determination as to the deductible mortgage interest was upheld.

In *Catalano*, the taxpayer had an outstanding mortgage balance of approximately $1.3 million.. The court computed the interest deduction allowed based on $1 million of acquisition indebtedness, citing *Pau*, but without analysis or discussion.

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In 2001, the Service examined this issue in FSA 200137033. In this instance, the taxpayers, a married couple, filed a joint return for the tax year. They claimed mortgage interest deductions for two residences. One residence was owned by the wife and a member of her family, but only the wife was listed as a borrower. The second residence was owned by the taxpayers jointly, and both were listed as borrowers. During that year, the taxpayers lived in a third residence, provided in connection with the husband's employment. However, the taxpayers claimed that the first residence was their principal residence.

The Service identified two issues to be resolved. First, were the taxpayers entitled to take mortgage interest deductions for a principal residence and one other residence during the time they occupied a third residence provided to them by the husband's employer? Second, what amount of mortgage interest were the taxpayers entitled to deduct?

The Service first concluded that the question of which residence was the taxpayers' principal residence was one of facts and circumstances. Once the principal residence was determined, the taxpayers could select one of the two remaining residences as their other residence. Because the jointly owned residence had been purchased during the tax year, the taxpayers could (assuming that the house provided by the husband's employer was their principal residence) select the house owned by the wife and her family as their second residence for the entire year. Alternatively, they could select that residence as their second residence for the part of the year they did not own the jointly held residence. In that case, the jointly owned residence would be their other residence for the part of the year they owned that residence.

The second question, the amount of interest that is deductible, is of more interest here. The Service began its analysis by pointing out that the Code limits the total amount of acquisition indebtedness to $1 million ($500,000 for a married taxpayer filing separately). Further the Code also limits the total amount of home equity indebtedness to $100,000 ($50,000 for a married taxpayer filing separately).

As a result, the Service concluded that the maximum amount of debt that could be taken into account for calculating interest on home acquisition indebtedness is $1 million ($500,000 for a married taxpayer filing separately) . The maximum amount that could be taken into account for calculating interest on home equity indebtedness is $100,000 ($50,000 for a married taxpayer filing separately).

If the loans on both homes, or only the jointly owned home (which was purchased in the tax year of the audited return), were acquisition loans, the amount of acquisition debt exceeded $1 million. The taxpayers were entitled to deduct interest on only $1 million of that debt.

If the loan on the property owned by the wife and her family member was home equity indebtedness, the $100,000 limit on home equity indebtedness would apply to that loan. However, because that loan balance was always under $100,000, all of the interest would be deductible.

Debt incurred to acquire residence can be deducted as home equity indebtedness

In 2009, the IRS issued CCA 200940030. This can not be cited as precedent, but a Chief Counsel Advice can provide insight into the thinking of IRS officials.

CCA 200940030 considered a taxpayer who purchased a principal residence for $1.5 million by putting down $200,000 and borrowing the remaining $1.3 million with a loan secured by the principal residence. The question asked was whether $100,000 of the indebtedness in excess of $1 million can qualify as home equity indebtedness. Because home equity indebtedness is defined as debt other than acquisition indebtedness, the IRS said that acquisition indebtedness must be defined before an answer can be determined.

CCA 200940030 first sets forth the statutory definitions of acquisition indebtedness and home equity indebtedness. Acquisition indebtedness is debt incurred to acquire, construct, or improve a qualified residence and which is secured by such residence. According to Section 163(h)(3)(B)(i), such debt may include debt from refinancing. Section 163(h)(3)(B)(ii) then provides: "The aggregate amount treated as acquisition indebtedness for any period shall not exceed $1,000,000

Taxpayers can now deduct interest on $1.1 million of debt used to acquire, construct, or substantially improve a qualified residence.

[1] Section 163(h)(3)(B)(ii).

[2] Section 163(h)(3)(C)(ii).

[3] See Rev. Rul. 2010-25, 2010-44 IRB 571.

[4] See Pau, TCM 1997-43 and Catalano, TCM 2000-82.

($500,000 in the case of a married individual filing a separate return)."

Under Section 163(h)(3)(C), home equity indebtedness is defined as debt other than acquisition indebtedness secured by a qualified residence subject to two limitations : (1) the fair market value of the residence reduced by acquisition indebtedness and (2) $100,000 ($50,000 in the case of a married person filing a separate return).

The Service saw two interpretations of the definition of acquisition indebtedness. Under the first interpretation, the $1 million limitation is not part of the definition of acquisition indebtedness, but merely a limitation on deductibility. In other words, acquisition indebtedness means all debt incurred to acquire, construct, or improve a qualified residence, regardless of the amount of debt.

Alternatively, the $1 million limitation may be part of the definition of acquisition indebtedness. Therefore, acquisition indebtedness is limited to $1 million. Any additional debt to acquire, construct, or improve a qualified residence is not acquisition indebtedness, but may qualify as home equity indebtedness.

The IRS decided that the second interpretation is the better interpretation. To arrive at this conclusion, the Service looked at Sections 163(h)(3), 108, and 56. Under Section 163(h), qualified residence interest is deductible interest. It is defined as interest paid or accrued during the tax year on acquisition indebtedness and home equity indebtedness. Therefore, acquisition indebtedness must by definition be limited to $1,000,000 ($500,000 in the case of married individuals filing separately); only interest on $1,000,000 ($500,000 in the case of married individuals filing separately) of debt can be deducted. Similarly, home equity indebtedness is limited to $100,000 ($50,000 in the case of married individuals filing separately); only interest on $100,000 ($50,000 in the case of married individual filing separately) can be deducted.

Section 108(a)(1)(E) excludes from income the discharge of qualified principal residence indebtedness. Section 108(h) then defines qualified principal residence by reference to Section 163(h)(3)(B)'s definition of "acquisition indebtedness." Section 108(h)(2) does this by substituting $2,000,000 for $1,000,000 and substituting $1,000,000 for $500,000 in Section 163(h)(3)(B).

According to the Service, this indicates that $1,000,000 is part of the definition of acquisition indebtedness because Section 108(h)(2) modifies the dollar limits in Section 163(h)(3). If this was not so, the IRS asserted, Section 108(h)(2) would not have changed the definition of qualified acquisition indebtedness. Rather, "it would suffice simply to state that acquisition indebtedness, limited to $2 million, is eligible for exclusion."

Section 56 is concerned with adjustments to compute the alternative minimum tax. Section 56(b)(1)(C) allows individuals to deduct qualified housing interest. Section 56(e)(1) defines "qualified housing interest" as qualified residence interest under Section 163(h)(3) paid or accrued on debt incurred to acquire construct, or improve a principal residence or qualified dwelling.

The Service believed that if qualified residence interest is not limited by definition to $1,000,000 for acquisition indebtedness ($500,000 in the case of a married individual filing separately) and $100,000 for home equity indebtedness ($50,000 in the case of a married individual filing separately), Section 56(e) could be read as allowing the deduction of all mortgage interest on a principal residence. According to the IRS in CCA 200940030, that is obviously contrary to the intent of Congress (which presumably was to allow, at most, an equal interest deduction for alternative minimum tax purposes as was allowed for regular income tax purposes) and cannot be a correct interpretation. Therefore, the dollar limitations are part of the definitions of acquisition indebtedness and home equity indebtedness.

The Service arrived at the same conclusion in Rev. Rul. 2010-25. The Ruling considered the case of an unmarried taxpayer who purchased a principal residence in 2009 for its fair market value of $1.5 million. The taxpayer put down $300,000 and borrowed the remainder through a mortgage secured by the residence. The issue was whether debt incurred to acquire, construct, or improve a qualified residence can be considered "home equity indebtedness" (as used in Section 163(h)(3)(C)) for amounts in excess of $1 million.

The Service answered in the affirmative, following the result of CCA 200940030. However,

[5] See CCA 200940030 and Rev. Rul. 2010-25, 2010-44 IRB 571.

[6] Section 163(h)(4)(A)(ii).

[7] See Section 163(h)(2).

the Service arrived at this result in Rev. Rul. 2010-25 by a somewhat different analysis.

It began by defining qualified residence interest, qualified residence, and acquisition indebtedness. Acquisition indebtedness is limited to $1 million ($500,000 in the case of a married individual filing separately). Therefore, any indebtedness to acquire, construct, or substantially improve a qualified residence that is secured by that residence in excess of those limits is not acquisition indebtedness.

The IRS then defined home equity indebtedness. Home equity indebtedness is limited to $100,000 ($50,000 in the case of a married individual filing separately). Therefore, any debt secured by a qualified residence that is not acquisition indebtedness (limited to the excess of the fair market value of the residence over the acquisition indebtedness), but exceeds the $100,000/$50,000 limits is not home equity indebtedness.

As a result, the Service concluded that the taxpayer could deduct as interest on acquisition indebtedness interest paid on $1 million of the $1.2 million debt incurred to purchase the taxpayer's principal residence. In addition, the taxpayer can deduct as interest on home equity indebtedness, the amount of interest paid on $100,000. The Service specifically rejected the reasoning of the Tax Court in *Pau* and stated that it would not follow the decisions in *Pau* and *Catalano:*

> The holding in *Pau* was based on the incorrect assertion that taxpayers must demonstrate that debt treated as home equity indebtedness "was not incurred in acquiring, constructing or substantially improving their residence." The definition of home equity indebtedness in § 163(h)(3)(C) contains no such restrictions, and accordingly the Service will determine home equity indebtedness consistent with the provisions of this revenue ruling, notwithstanding the decisions in *Pau* and *Catalano.*

Impact of IRS position change

The Service did not explain why its position changed in Rev. Rul. 2010-25 and Chief Counsel Advice 200940030. Nonetheless, the conclusions of these new announcements are welcomed by taxpayers and practitioners. What are the implications of the Service's new position?

Taxpayers can now deduct interest on $1.1 million of debt used to acquire, construct, or substantially improve a qualified residence. Since a taxpayer can deduct interest on two residences,[6] the $1.1 million limit applies to two residences together. If, for example, a taxpayer has $500,000 mortgage against one residence, he or she can acquire a second residence and deduct interest on up to $600,000 of debt used to acquire or construct that residence. Similar rules would apply to debt incurred to improve a residence—the debt to acquire and improve one or two residences can equal up to $1.1 million and the interest on that debt will be deductible.

Practitioners should, going forward, make sure that they are deducting interest on the maximum amount of debt possible. In addition, practitioners can examine prior years' returns to determine if additional interest could have been deducted. While interest rates are low, the interest paid on $100,000 of debt could be from $3,000 to $5,000. The federal tax savings at 35% could be from $1,050 to $1,750—a not-insignificant sum. State tax savings will increase that amount.

It is also important to remember that these rules apply to personal interest. They do not apply to interest incurred for trade or business purposes, for investment purposes, or for computing income or loss from passive activities.[7] Practitioners should therefore be careful to classify interest paid by their clients properly.