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IRS Breaks With Tax Court on Deduction Limits

Kimberly Stanley

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The deduction of home mortgage interest is one of the most valuable and hotly debated benefits provided in the tax code to individuals. Since 1987, the code has restricted the interest deduction based on the amount of home mortgage debt the taxpayer has incurred, and the reasons for the debt. In a recent ruling, however, the Internal Revenue Service announced it would not follow a court ruling that limited the amount of deductible home mortgage interest — noteworthy because this time the IRS ruled in the taxpayer's favor.

In general, a taxpayer may deduct a certain amount of interest paid on a loan secured by his or her main home, or a second home, whether the loan is a first or second mortgage, a home equity loan, or line of credit. To claim the deduction, the taxpayer must file a Form 1040 and itemize deductions, the loan must be a bona fide legal obligation of the taxpayer, and the debt must be secured by a home in which the taxpayer has an ownership interest. For mortgages taken out after Oct. 13, 1987, the amount of interest that is deductible depends on the amount of the mortgage and how the taxpayer uses the loan proceeds. Under IRC §163(h)(3), individuals may deduct interest on "acquisition indebtedness" and "home equity indebtedness" if the indebtedness is secured by the taxpayer's principal residence and/or one other residence used by the taxpayer. "Acquisition indebtedness" is any debt that the taxpayer uses to acquire, construct, or substantially improve a personal residence; however, acquisition indebtedness is capped at \$1 million. Thus, interest paid on any debt in excess of \$1 million is not deductible, even if the loan proceeds are used to acquire, construct, or substantially improve a personal or secondary residence. However, the code also allows a taxpayer to deduct interest paid on up to \$100,000 of "home equity indebtedness" — defined as any interest paid on "indebtedness (other than acquisition indebtedness)" that is secured by the taxpayer's residence, so long as there is sufficient equity in the property (i.e., the fair market value of the residence must exceed the amount of the acquisition debt on the property by at least the amount of the home equity indebtedness, measured as of the time of the borrowing).

In light of the statutory definition of "home equity indebtedness" as "any indebtedness (other than acquisition indebtedness)" the tax court has not allowed a taxpayer to deduct interest on a home equity loan if the home equity loan proceeds were used to acquire, construct or improve a personal residence. If a home equity loan is used for any other purpose — whether it be for your son's tuition, a vacation to Bali or to pay down consumer credit cards — interest on such a loan up to \$100,000 is deductible (so long as the loan is secured by the equity in the home). But a taxpayer has not been able to treat an additional

\$100,000 of debt as "home equity indebtedness" if the proceeds were used for home acquisition purposes, even if there was sufficient equity in the home. *Pau v Commissioner*, T.C. Memo 1997-43, and *Catalano v Commissioner*, T.C. Memo 2000-82. The tax court ruled that if a taxpayer uses all of the mortgage debt to acquire a personal residence, it was characterized as acquisition indebtedness, and under the statute, interest paid on acquisition indebtedness in excess of \$1 million is not deductible. IRC §163(h)(3)(C).

Earlier this year, however, the IRS issued a ruling allowing taxpayers to treat an additional \$100,000 of mortgage debt that is used to acquire, construct or substantially improve a qualified residence as "home equity indebtedness" under IRC §163(h)(3)(C). As a result, taxpayers may now deduct interest on up to \$1.1 million of debt that is used to acquire, construct or improve a personal residence. The ruling announced that the IRS would no longer follow the Tax Court's holding disallowing deduction of interest on home equity loans if used to acquire, construct or substantially improve one's personal residence.

In the ruling, the taxpayer purchased a principal residence for \$1,500,000, paying \$300,000 down and financing the remaining \$1,200,000 through a loan secured by the residence. The taxpayer paid interest accruing on that indebtedness, but had no other debt secured by the residence. The IRS ruled that the taxpayer could deduct interest on \$1,000,000 of the indebtedness under §163(h)(3)(B) because it was "acquisition indebtedness" used to acquire the residence. The IRS went on to hold that the taxpayer may also deduct, as interest on "home equity indebtedness" under §163(h)(3)(C), interest paid on an additional \$100,000 of the remaining indebtedness of \$200,000. Accordingly, the taxpayer was allowed to deduct interest on an additional \$100,000 of the debt as "home equity indebtedness" even though it was used to acquire, construct, or substantially improve the home.

In short, under this ruling, a taxpayer may now deduct interest on up to \$1.1 million of debt that is used to acquire, construct, or substantially improve a primary or second home, so long as there is at least \$100,000 of home equity securing the loan. The IRS expressly rejected the court's holding that a taxpayer must demonstrate that debt treated as home equity indebtedness was not used for acquisition purposes because the definition of "home equity indebtedness" in §163(h)(3)(C) contains no such restriction.

This is, of course, a welcome clarification for taxpayers. The common understanding of "home equity indebtedness" is that the taxpayer can use the proceeds of the loan for any purpose, without restriction. The [IRS Publication on Home Mortgage Interest](#) (Publication 936, p 9) confirms that home equity indebtedness can include debt used to acquire a home if it exceeds the \$1 million acquisition indebtedness limit. Whereas the code defines acquisition indebtedness as funds that are used for a specific purpose (to acquire, construct or substantially improve a home), there is no restriction on the definition of home equity debt. The IRS ruling logically clarifies this to include the additional \$100,000 of home equity debt. Moreover, although the precedential value of a revenue ruling generally does not 'trump' an opinion of the Tax Court (which has nationwide jurisdiction), when the IRS position is more favorable to the taxpayer than the court's, the issue is unlikely to be raised at the audit level. Consequently, the IRS has signaled to taxpayers that they will not be challenged on audit if they deduct interest on up to \$1.1 million of indebtedness that is used to acquire, construct, or improve their primary residence and/or one additional residence if there is at least \$100,000 of equity in the home or homes that secure the mortgage.

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