Mortgage Interest and the Tracing Regulations After the Tax Cuts and Jobs Act of 2017

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IRS Chief Counsel Advice Number 201201017 (Nov. 1, 2011)

IRS LTR 201201017

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PART I: RULES

Learning Objectives

- Know where to find the interest deduction in the Internal Revenue Code.
- Use the statute to define qualified residence interest, acquisition indebtedness, and home equity indebtedness.
- Understand the changes to the mortgage interest deduction brought about by the TCJA.
- Identify the situations in which allocation is needed.
- Identify the situations in which tracing is needed.
- Use the Treasury Regulations to allocate debt to different categories.
- Know when to ask clients for more information when they present a Form 1098.

I. BACKGROUND MATTERS

The Statute

Internal Revenue Code Section 163(a) provides the general deduction for interest paid or incurred:

> Internal Revenue Code §163(a) General rule: *There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.*

The Internal Revenue Code often follows this format: a broad general rule, followed by a broad disallowance, followed by exceptions to the disallowance. Generally speaking, *exceptions* to a rule are construed narrowly.

Other parts of IRC §163 provide rules for limiting investment interest, dealing with original issue discount and others. For individuals, though the Code follows the pattern – Interest is deductible, but NOT if you're an individual, UNLESS it's one of the exceptions. The exceptions are listed in Subsection 163(h):

- Interest incurred in a trade or business
- Investment interest (subject to limitations)
- Passive activity interest sec. 469
- Qualified residence interest
- Sec. 6601 interest on unpaid estate tax
- Student loan interest sec. 221

In this case, the deduction for *qualified residence interest* is an exception to a *disallowance* of a deduction that was otherwise broadly available.

History. Before 1986, interest was generally deductible for all taxpayers, including individuals. The Tax Reform Act of 1986, Pub. L. 99-514, sec. 511(b), made personal interest nondeductible and imposed significant limitations on other kinds of interest. The 1987 Act further refined the new disallowances and the result was what we will now call the **Old Rules.**

> The Tax Reform Act of 1986:
>
> - Limited the deduction for investment interest to the amount of net investment income of the taxpayer for the taxable year and allowed a carryover of any disallowed investment interest to the succeeding taxable year.
> - Disallowed an income tax deduction for personal interest expenses of individuals, defining "personal interest" as any interest paid or incurred except:
>   (1) in connection with the conduct of a trade or business;
>   (2) investment interest;
>   (3) interest used in computing income or loss from a passive activity;
>   (4) home mortgage interest; and
>   (5) interest on tax deficiencies.

The Regulations

Treasury provided temporary regulations shortly after the 1986 tax reform. Those regs are found at Treas. Regs. 1.163-8T. Treasury also provided regulations on the new Qualified Residence Interest. Those are found at Treas. Reg. 1.163-10T. Unfortunately, most of the 10T regs were obsolete almost immediately when Congress revised the new law in 1987, adding the $1 million and $100,000 limitations with which we are now so familiar.

The Old Rules

Under the old rules, that is, the interest deduction before the Tax Cuts and Jobs Act*, "Qualified Residence Interest"* is the interest on two kinds of qualified residence indebtedness:

1. Acquisition Indebtedness = debt used to buy, build, or improve a principal residence and secured by that residence. No more than $1,000,000 could be treated as acquisition indebtedness at a time.
2. Home Equity Indebtedness = debt secured by a principal residence that is NOT acquisition indebtedness. No more than $100,000 could be treated as "home equity indebtedness).

Thus, under the old rules, taxpayers could deduct interest on up to $1.1 million of mortgage debt as qualified residence interest.[1]

[1] Pau v. Commissioner , T.C. Memo. 1997-43, the Tax Court held that no part of a debt used to acquire or improve a residence could be home equity indebtedness even if the debt was over 1 million. The court said that all $1.3 million of the debt was acquisition indebtedness. Many people thought this was the wrong way to read the statute. Even the IRS (who won the case) thought it was wrong, and said so in Rev. Rul. 2010-25.

Reading the Code

1. Note that when the Internal Revenue Code uses an adjective and a noun together (“noun phrase”), there is usually a definition like the one above. Some grammar review:

   Home equity

   “Home” = adjective here because it modifies equity
   “Equity” = noun

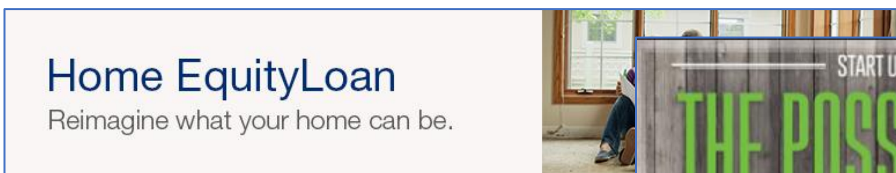
   Home equity indebtedness

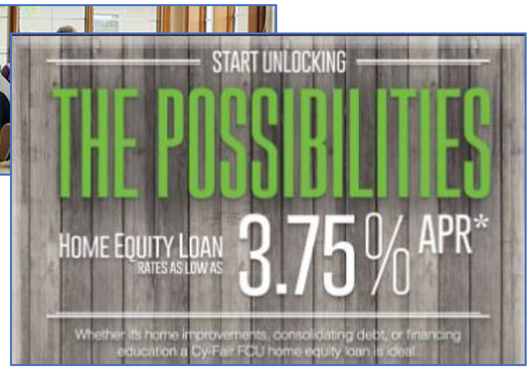
   Home equity” = adjective here because it modifies indebtedness
   “Indebtedness” = noun

Since there are adjectives and nouns, there is a definition in the Code. *“Home equity indebtedness*” is a tax term of art.

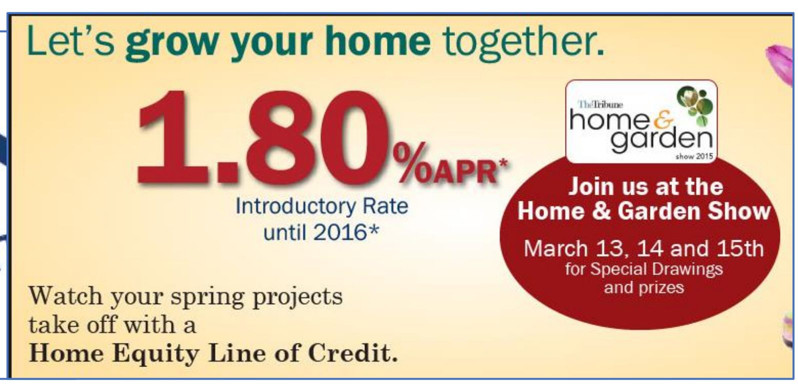
If there were no definition, there would probably be litigation.

Banks offer “home equity loans”





And many banks offer a “Home Equity Line of Credit”



HOME EQUITY in these ads is NOT necessarily the same as “*Home equity indebtedness”* under the Internal Revenue Code.

2. We should stick with the Code definitions. Under the new regime,

qualified residence indebtedness means *acquisition indebtedness.*

(3) QUALIFIED RESIDENCE INTEREST For purposes of this subsection—

(A) **In general** The term "qualified residence interest" means any interest which is paid or accrued during the taxable year on—

(i) acquisition indebtedness with respect to any qualified residence of the taxpayer

The TCJA took away (ii) which was home equity indebtedness.

3. And *acquisition indebtedness* is defined as debt that:

(I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and

(II) is secured by ***such*** residence.

IRC §163(h)(3)(B)(i).

4. Notice that the debt must be secured by the same residence that is acquired, constructed, or improved. This was always the definition of *acquisition indebtedness*.

5. *Acquisition indebtedness* is limited to $750,000, and it also includes refinancing of debt that meets the definition above.[2]

What the bank calls the loan is irrelevant.

Mortgage Interest – New Rules

There are two changes:

1. The limit on Acquisition Indebtedness is now $750,000, instead of $1,000,000.
2. Qualified Residence Interest MEANS interest on Acquisition Indebtedness.

The TCJA -- added a new provision to make these changes. The new provision merely states that the paragraph about home equity indebtedness does not apply. Ergo, home equity indebtedness is no longer an exception to the rule that there is no deduction for interest on personal indebtedness.

In addition, acquisition indebtedness incurred before December 15, 2017, is grandfathered in with the $1,000,000 limit. Grandfathered debt can also be refinanced, but there are some limitations on the refinancing.

[2] There is a new limit on refinanced debt, which we will explain later.

163(h)(3)(F) Special rules for taxable years 2018 through 2025

(i) In general In the case of taxable years beginning after December 31, 2017, and before January 1, 2026—

(I)Disallowance of home equity indebtedness interest
Subparagraph (A)(ii) shall not apply.

(II)Limitation on acquisition indebtedness
Subparagraph (B)(ii) shall be applied by substituting "$750,000 ($375,000" for "$1,000,000 ($500,000".

Things to notice:

1. *Qualified residence interest* used to have two components: interest on acquisition debt and interest on home equity indebtedness. Now it has one.

2. Subparagraph (A)(ii) is made inapplicable through 2025.

3. Although the heading for new Sec. 163(h)(1)(F)(i)(I) uses the word "Disallowance," no provisions were actually repealed. The definition for "Home equity indebtedness" still exists in the Code, but it has no effect for now (except to keep us confused). Home equity indebtedness does NOT give rise to qualified residence interest.

4. The definition of acquisition indebtedness has not changed, but the limit has been lowered. Acquisition indebtedness is still

Used to acquire, construct, or improve
A principal residence
And is secured by *that same* residence.

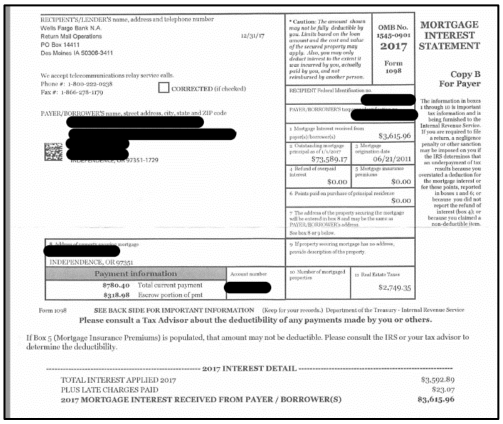
THIS IS NOT NEW

Form 1098 – Information

When clients bring us form 1098, what do we actually know? Some or all of this, but not much more:

- Total interest received
- Principal at beginning of year
- Mortgage origination date
- Interest refunded
- Mortgage insurance premiums

- Points paid on purchase of principal residence.


RECIPIENT'S/LENDER'S name, address and telephone number
Wells Fargo Bank N.A.
Return Mail Operations
PO Box 14411
Des Moines IA 50306-3411
12/31/17

We accept telecommunications relay service calls.
Phone #: 1-800-222-0238
Fax #: 1-866-278-1179

☐ CORRECTED (if checked)

PAYER/BORROWER'S name, street address, city, state and ZIP code
[redacted] 97351-1729

* Caution: *The amount shown may not be fully deductible by you. Limits based on the loan amount and the cost and value of the secured property may apply. Also, you may only deduct interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person.*

OMB No. 1545-0901
2017
Form 1098

MORTGAGE INTEREST STATEMENT

Copy B
For Payer

RECIPIENT Federal Identification no. [redacted]

PAYER/BORROWER'S tax[redacted]

1 Mortgage Interest received from payer(s)/borrower(s) $3,615.96	
2 Outstanding mortgage principal as of 1/1/2017 $73,589.17	3 Mortgage origination date 06/21/2011
4 Refund of overpaid interest $0.00	5 Mortgage insurance premiums $0.00
6 Points paid on purchase of principal residence $0.00	
7 The address of the property securing the mortgage will be entered in box 8 and may be the same as PAYER/BORROWER's address. See box 8 or 9 below.	

The information in boxes 1 through 10 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for the mortgage interest or for these points, reported in boxes 1 and 6; or because you did not report the refund of interest (box 4); or because you claimed a non-deductible item.

[redacted] mortgage
INDEPENDENCE, OR 97351

9 If property securing mortgage has no address, provide description of the property

Payment information		Account number	10 Number of mortgaged properties	11 Real Estate Taxes
$780.40	Total current payment	[redacted]		$2,749.35
$318.98	Escrow portion of pmt			

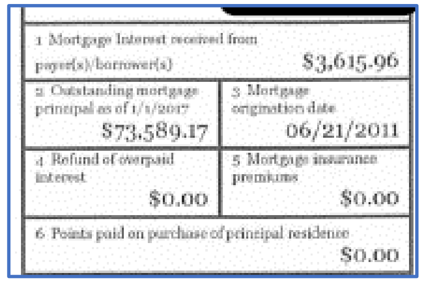
Form 1098 SEE BACK SIDE FOR IMPORTANT INFORMATION (Keep for your records.) Department of the Treasury - Internal Revenue Service

Please consult a Tax Advisor about the deductibility of any payments made by you or others.

If Box 5 (Mortgage Insurance Premiums) is populated, that amount may not be deductible. Please consult the IRS or your tax advisor to determine the deductibility.

2017 INTEREST DETAIL

TOTAL INTEREST APPLIED 2017	$3,592.89
PLUS LATE CHARGES PAID	$23.07
2017 MORTGAGE INTEREST RECEIVED FROM PAYER / BORROWER(S)	**$3,615.96**



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Chaos and Confusion–

1986 Confusion. When broad categories are changed or created, we experience some upheaval. After 1986, some interest was deductible, and some was not.

How does the deduction work when there are so many categories?

a) What if I take out one big loan and use some of it for each of these?

b) What if I take out a loan and use part of it for a house and part of it for something else?

c) Part house, part investment, part boat, part business?

The different categories create a need to allocate loan proceeds to the different kinds of debt so that we can identify deductible and non-deductible interest. There are various ways to allocate.

II. THE TRACING REGULATIONS

A. Introduction to Regulations

1. Regulations are "promulgated" by the Treasury Department. The individual people who write the regulations may be working in the IRS, which is housed within the Treasury Department, but technically, the regulations do not come from the IRS. (Revenue Rulings, however, DO come from the IRS and sometimes they contain language that is almost identical to regulations that are promulgated at the same time.)
2. Two kinds of regulations:

a) Interpretive Regulations – these explain a Code section and show how the statute applies in various situations. They do not add new rules.

b) Legislative Regulations – these provide rules that the Code does not. Congress effectively empowers the Treasury to finish writing the law:

> "The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection"

B. Regulation numbering.

1.163-8T

T for temporary

a) The 1 before the period m

Reg number

b) The number after the period and before the hyphen is the Code section

c) The regs themselves are numbered after the hyphen. The "T" means temporary. Sometimes regs are temporary for a long time. Temporary does not mean proposed.

1. Temporary regs apply just like permanent regs.
2. Proposed regs are only proposed, but it is a good idea to follow them (like private letter rulings)
3. These regs have been temporary since 1987 (with a minor numbering correction in 1997). We will work with these regulations a bit later.

A loan or line of credit secured by a principal residence may be used for various purposes.

- *Acquisition indebtedness* IF the proceeds are used to acquire, construct, or improve the principal residence that secures the loan.
- A business loan that happens to be secured by the residence.
- A qualified education loan under IRC §221 if the proceeds are used for qualified higher education expenses. (See IRC § 221.)
- An investment loan.
- A truly personal loan used to fund a vacation.

Observation:

Form 1098 tells us one thing: The debt is secured by a residence. We must ask the client how the proceeds were used. And when.

→ Just as we had to start distinguishing between personal interest and home equity indebtedness back in 1987, we now must distinguish between acquisition indebtedness and personal interest.

C. OVERVIEW

1. Outline of the -8T regs. There are 14 subsections, but 6 of them have no content. How bad can this be?!
2. Three main activities are addressed in the regs:

   a) Allocate new debt to expenditures to determine type of debt.

   b) Allocate repayment to the types of debt.

   c) Reallocate debt when assets change or debt is refinanced.

3. Basic Principles

   a) Interest is allocated the same as the debt.

   b) Debt is allocated based on expenditures made with the proceeds.

   c) When the use of the proceeds changes, the debt is reallocated.

   d) When debt is repaid, the regulations specify the order in which different kinds are repaid.

Treas. Reg. sec. 1.163-8T Subsections

- (a) In general
- **(b)** Definitions
- **(c) Allocation of debt and interest expense**
- **(d) Debt repayments**
- **(e) Debt refinancings**
- (f) Reserved
- (g) Reserved
- (h) Reserved
- (i) Reserved
- **(j) Reallocation of debt**
- (k) Reserved
- (l) Reserved
- (m) Coordination with other sections
- (n) Effective dates

D. GENERAL ALLOCATION RULES

1.163-8T(a)(3), and 1.163-8T(c)(1).

1. INTEREST IS ALLOCATED THE SAME AS DEBT
   Interest expense on a debt is allocated in the same manner as the debt to which the interest expense relates. In other words:

   a) Interest expense allocated to an investment expenditure is treated as investment interest under 163(d).

   b) Interest expense allocated to a passive activity expenditure us taken into account under 469 in determining passive activity income or loss.

c) Interest expense allocated to a personal expenditure is personal interest under 163(h).

2. DEBT GOES BY EXPENDITURE
Debt is allocated to an expenditure for the time period beginning when the proceeds are used to make the expenditure and ending when the debt is repaid (unless it is reallocated).

d) This is particularly important for allocating interest to a passive activity and a former passive activity when the participation changes.

e) This also matters if the proceeds are not used right away.

f) This also matters if the use of the proceeds changes.

3. BANK ACCOUNTS ARE INVESTMENTS
Debt proceeds deposited in a bank account are treated as an investment expenditure until they are spent. It does not matter whether or not the account bears interest. When the money is spent, the debt is *reallocated*.

g) Example: C borrows $100,000 on January 1 and opens a noninterest bearing checking account. On April 1, C uses $20,000 for a passive activity expenditure. On September 1, C uses $40,000 for a personal expenditure.

We analyze each time period separately. From January 1 to March 31, there is only one use for the proceeds (being in a bank account), so all of the interest for 3 months is investment interest. From April 1 through August 31, there are two uses because some of the proceeds were used for the passive activity.

Jan 1 – Mar 31	$100,000	investment	Holding funds in a bank account (even non-interest-bearing) is treated as an investment.
April 1 – Aug 31	20,000	Passive activity	Part of the loan is reallocated to the passive activity.
	80,000	Investment	Still in the bank account.
Sept 1 – Dec 31	20,000	Passive activity	No change
	40,000	Personal	Part of the loan is reallocated to the personal expenditure.
	40,000	Investment	Still in the bank account.

h) Implications: We have to ask more questions than we have been used to. Note that this analysis applies to ANY loan, not just one secured by a residence.

i) Under prior law, this might have been reported on a 1098. Even then, we should have been asking questions.

4. COLLATERAL DOESN'T MATTER
Character of security does not generally matter.

j) "debt proceeds and related interest expense are allocated solely by reference to the use of the proceeds."

k) The use of property used as security does not matter.

EXAMPLE: Alan Aardvark pledges corporate stock held as an investment as security for a loan. He uses the proceeds to buy a personal car. Is this investment interest? Or personal interest? (PERSONAL)

Alan Aardvark pledges his principal residence as security for a loan. He uses the proceeds to buy a personal car. Is this qualified residence interest? Or personal interest? (STILL PERSONAL)

Alan Aardvark pledges his donut machine used in his trade or business as security for a loan. He uses the proceeds to buy a personal car. Is this business interest? Or personal interest? (STILL PERSONAL)

E. RULES FOR MULTIPLE LOANS IN THE SAME BANK ACCOUNT

What happens if the taxpayer deposits proceeds from more than one loan in the same account, and then makes expenditures from the funds in the account? For example, Terry Taxpayer takes out a loan from Main Street Bank and deposits proceeds in a bank account. As plans develop, it becomes clear that won't be enough, so Terry takes out a second loan from Center Street Bank and deposits the proceeds in the same account. Terry makes payments out of the account to start a business, buy some stock, and pay passive activity expenses. The loans, of course, have different interest rates. So we need rules to allocate the loans to the different expenditures. Regs section 1.163-8T(c)(4)(ii) provides some rules.

1. DEBT FIRST

Debt proceeds in an account are expended before Unborrowed amounts

2. FIRST IN FIRST OUT
   Debt proceeds are expended before later deposits

   a) EXAMPLE from Regs: On January 10, Elmer deposits $500 proceeds of Debt A and $1000 of unborrowed funds in a new account. Then Elmer enters into other transactions as shown in this table:

Date	Transaction	Rule	Analysis	Balance
Jan. 10	Deposit $500 Debt A, $1000 Unborrowed	Invest	Character of Debt A is investment	
Jan. 11	Deposit $500 Debt B		$1000 unborrowed, $500 Debt A, $500 Debt B	2000
Feb. 17	Spend $800 for a new set of skis	Debt First Timing	All $800 will come from the two debts. $500 from A; $300 from B $1000 unborrowed, $200 Debt B	$1200
Feb. 26	$700 passive activity expenditure	Debt first	$200 is from Debt B; $500 is unborrowed Remaining $500 is unborrowed	$500
June 21	Deposit $1000 Debt C		$1000 is debt C; $500 unborrowed	$1500
Nov. 24	$800 investment exp	Debt first	Debt first -- $800 Debt C $200 is debt C; $500 unborrowed	$700
Dec. 20	$600 Personal expenditure	Debt First	$200 Debt C; $400 is unborrowed	
			Balance is now $100 unborrowed.	$100

Or, to summarize what happens to each Loan:

Debt A   Jan 10 to Feb 17   Investment (while in the account)
          Feb 17 to Dec 31   Personal

Debt B   Jan 10 to Feb 17   Investment
          Feb 17 to Feb 26 $300 Personal, $200 investment
          Feb 26 to Dec 31 $300 Personal, $200 passive activity

Debt C   June 21 to Nov 24   Investment (bank account)
          Nov 24 to Dec 20 $800 investment (purch), and $200 investment
          Dec 20 to Dec 31 $800 investment, $200 personal

F. ADDITIONAL ALLOCATION RULES -- EXPENDITURES

1. CHECK RULE,

   Payment made by check is made when check is written assuming it is delivered or mailed within a reasonable period thereafter. Reg. 1.163-8T(c)(4)(iii)(A).

2. SAME DAY RULE

   Checks written on the same day are made in whatever order taxpayer chooses. Reg. 1.163-8T(c)(4)(iii)(A).

3. 15-DAY RULE

   Taxpayer can choose to treat a purchase within 15 days of a deposit loan proceeds as coming out of the deposited funds. Reg. 1.163-8T(c)(4)(iii)(B) and (c)(5)(i).

G. ADDITIONAL ALLOCATION RULES -- DEPOSITS

1. SIMULTANEOUS DEPOSITS

   If deposits are made on the same day, look at the date of the debt. Reg. 1.163-8T(c)(4)(v)(A).

2. SIMULTANEOUS DEBT

   If debts are borrowed on the same day, taxpayer chooses. Reg. 1.163-8T(c)(4)(v)(B).

3. VARIABLE INTEREST RATES

   If the interest rate is not the same for the entire borrowing, each different interest rate portion is treated as a separate debt. Reg. 1.163-8T(c)(4)(v)(C).

Example.

Tilly incurred a $1000 debt on August 4 and received the debt proceeds in cash. On the same day, she received a check for a Bank Loan she had signed for on July 30, which she deposited along with the cash on August 15. On August 27, she wrote a check on the account for a passive activity expenditure. Naturally, she had other cash transactions and numerous deposits of borrowed and unborrowed amounts, as well as payments with her debit card for dining, gas, and miscellaneous expenses during those two weeks.

a) Two debts were received and deposited on the same day. The loan received by check, however, was incurred earlier so it is treated as deposited first.

b) She wrote a check for a passive activity expenditure on August 27.

In general, the <u>date on the check</u> is the date the expenditure was made (assuming the check went through promptly)

The general rule of <u>First In First Out</u> would treat the passive activity expense as coming from the Bank Loan if that amount had not already been spent on personal expenditures.

However the <u>15-day cash</u> rule allows her to treat $1000 of the passive activity expenditure as coming from the cash, since the expenditure was less than 15 days after the deposit.

H. Determining deductible interest when the debt is too large.

If acquisition debt exceeds the limitation (whether it is grandfathered in at 1M or is new debt limited to 750K), taxpayers may use a reasonable method to determine deductible *qualified residence interest*.

The methods for allocation are described in the -10T regs, and there is a worksheet in Publication 936.

CAUTION: The methods as described don't exactly work because they were meant to apply to home equity debt. Home equity debt that exceeded the limit could be allocated under 8T.

The 10T regs provide a "simplified method" and an "exact method."

1. Simplified method / worksheet method: The total acquisition debt is prorated based on the *average balance* of each loan.

Example: Taxpayer's residence secures two loans, both of which qualify as acquisition indebtedness. Loan A was used to purchase the residence and now had an average balance of $650,000 for 2018. Loan B was used to build an addition and it had an average balance of $300,000. In 2018, Taxpayer paid $26,000 on Loan A and $15,000 on Loan B.

Analysis:

a) It is clear that there is too much acquisition indebtedness if the limit is $750,000. Assume the new limit applies here.

b) The total interest was $41,000

c) Multiple total interest by a fraction where the numerator (the top number) is the acquisition debt limit = $750,000 and the denominator is the total of the average balances or $950,000.

$$\text{Total interest} \quad \times \quad \frac{\text{Debt Limit}}{\text{Total Debt}}$$

41,000 x 750,000/950,000 = $32,368

This is the deductible portion under the Simplified method.

d) The rest of the interest can be allocated under the -8T regs, but unless this residence is used for a trade or business or rental, the rest of the interest will be personal interest.

2. Exact Method:

The deductible interest is determined loan by loan. Each loan will have a different limit. The limit for the first loan is the total limit, or $750,000 in our example. The limit for the next loan is $750,000 minus the average balance of the first loan.

e) The average balance for Loan A was $650,000, which is less than the $750,000 limit, so all of the interest on loan A is deductible.

f) The limit for Loan B is determined by subtracting the average balance of the previous loan(s) from the overall limit.

$750,000 - $650,000 = $100,000

g) We multiply the Loan B interest by a fraction as we did before:

$$\text{Loan B interest} \quad \times \quad \frac{\text{Loan B limit (as determined)}}{\text{Loan B average balance}}$$

$15,000 x 100,000/300,000 = $5,000

This is the part of the Loan B interest that is deductible.

Total qualified residence interest under the exact method:

Loan A interest + Loan B interest= 26,000 + 5,000 = $31,000

The remaining interest can be allocated under the -8T rules, but will likely just be personal interest.

Note that the two methods yield different results because in the simplified method, later loans account for more of the deductible interest. In this example the later loan had a higher interest rate. If the Loan A interest rate had been higher, the results would have been reversed.

CAUTION: The -10T regs state that under the simplified method, all excess interest is treated as personal interest. However, the Pub 936 worksheet method is the same as the simplified method, and the excess interest IS allocable under the -8T regs. The IRS allows any reasonable method. *See* Notice 88-74.

III. REFINANCING, REPAYMENT, AND REALLOCATION

A. REFINANCING

The general rule is that refinanced acquisition debt is also acquisition debt.

a) Caution: If the debt increases, the excess is NOT acquisition debt. In other words, any cash back on the refinancing does not qualify.

b) There is also a time limit. Refinancing cannot lengthen the time period (and still count as refinanced acquisition debt).

c) The rule is:

- Under 163(h)(3)(F)(iii) refinanced pre-Dec 15, 2017 debt can be treated as acquisition debt until the original term expires.
- If the original debt was not self-amortizing, the refinancing counts until the expiration of the first refinancing or 30 years after the first refinancing, whichever comes first.

d) A similar rule applied to grandfathered debt from 1987.

- Under 163(h)(3)(D) refinanced pre-1987 debt can be treated as acquisition debt up until the original term expires.
- If the original debt was not self-amortizing, the refinancing counts until the expiration of the first refinancing or 30 years after the first refinancing, whichever comes first.

B. REPAYMENT ORDERING RULES.

We generally know whether a particular debt has been repaid, but when the debt has been used for multiple purposes, we need to know which portion has been repaid. When a debt has multiple characters, the regs provide the order of repayment. General order (for a mixed purpose loan). Under Treas. Reg. 1.163-8T(d)(1), debt is treated as repaid in this order:

1- Personal
2- Investment or passive activity
3- Rental passive activity w/ active participation
4- Former passive activity
5- Trade or business

a) First Allocated First Paid – If there is more than one expenditure in the same category, they are treated as repaid in the same order in which they were allocated.

b) Qualified Residence interest is "personal" interest under the -8T regs. So presumably rule b) applies to allocate repayment between personal and residence interest. However Pub. 936 has a mini set of ordering rules:

1. Home equity Debt
2. Grandfathered acquisition debt
3. Acquisition Debt

The publication needs to be updated. Home equity debt should be replaced with Personal.

3. Tax Prep Note:

When we enter the mortgage interest as an indirect expense on the office in home worksheet, and the software does the allocation and carries the rest to Schedule A, we are essentially using a *reasonable method* to allocate the interest according to use of the debt as required in 8T.

Keep in mind that 163(h)(3) is supposed to be good news, not bad news.

Example: Client George comes in with his 1098s. George will receive two forms 1098 for 2018.

- A 1098 for an acquisition loan showing:
  - $22,334 interest paid
  - $8066 principal paid
  - $491,934 remaining balance

- A 1098 for the second loan showing
  - $11,933 interest paid
  - $2,456 principal paid
  - $197,544 remaining balance

After asking questions, you learn the following:

In 2017, George borrowed $500,000 at 4.5% to purchase his home in Lake Oswego for $650,000 and secured the loan with the residence.

On January 1, 2018, he borrowed $200,000 at 6% secured by the residence. He used

- $50,000 to add a deck (assume this is an improvement).
- $50,000 to buy a tax franchise because he had always wanted to own his own business (even though he knew nothing about tax).
- $20,000 to attend a university to study history. The $20,000 went for tuition and fees.
- $50,000 to invest in mutual funds, and
- left the remaining $10,000 in his personal checking account.

How would you have approached George's 1098s in 2017? In 2018?

Add up all the interest and plug it in on Schedule A?

Take all of the interest on Loan 1 plus half the interest on Loan 2?

Allocate the loan 2 interest somehow? (But how?)

Another History Detour

In 1987, there were three kinds of deductible mortgage interest:

1. Grandfathered debt
2. New acquisition debt
3. Home equity debt

In the 1986 Act, there were no dollar limitations on residence indebtedness; rather, the total debt could not exceed the value of the home when the debt was borrowed.

Congress added the dollar limitations AFTER the 10T regs came out.

In 1987 the dollar limitations of $1,000,000 on acquisition indebtedness and $100,000 on home equity indebtedness were much more generous than they are now: Consider:

Metro Area	**Median Home Value 1986**	**Median Home Value 2016**
San Francisco	$160,955	$1,058,474
Seattle, WA	$81,774	$412,286
Portland, OR	$63,154	$313,079
Orange County, CA	$143,210	$643,483
Los Angeles, CA	$116,061	$520,060
Miami, FL	$62,385	$249,326

The standard deduction was lower relative to household income:

Single or head of household was $2540, and married filing joint was $3760.

Median household income was $24635.

The standard deduction for a single person was thus 10.3% of MHI, and the standard deduction for a married couple was 15.3% of MHI.

To buy the median home in Portland with 20% down, the buyer would borrow about $50,000 at 9.2% in 1987. Monthly payments would be $413. The interest in the first year would be over $4600.

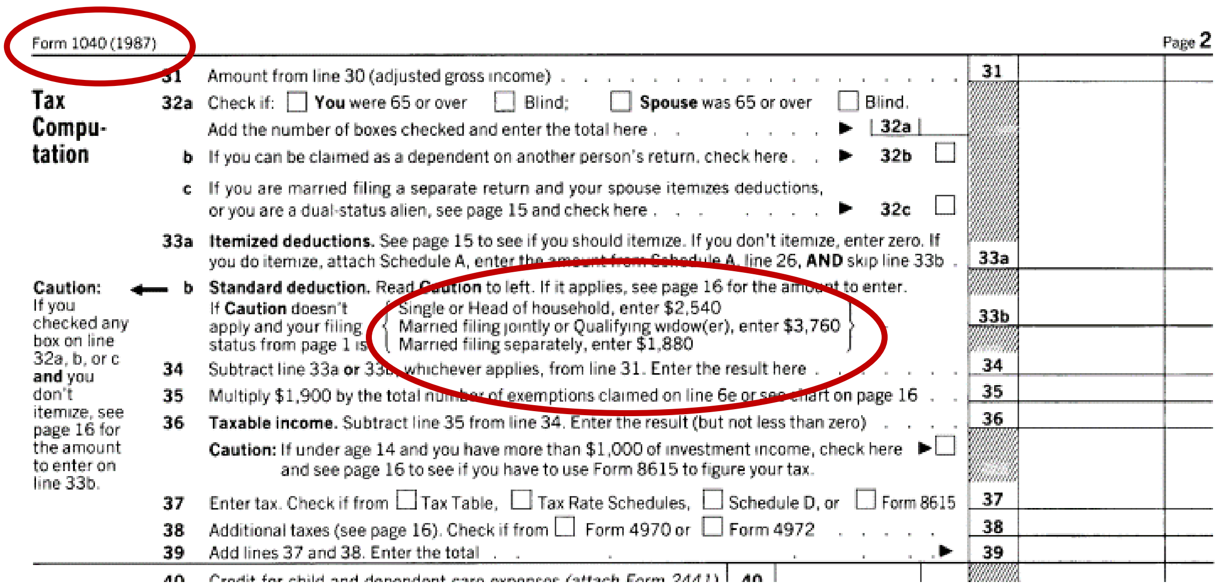
In other words, interest that could be treated as qualified residence interest in 1986 was almost certainly deductible.

Now mortgage interest is far less likely to be deductible.
For 2014, median household income was $53,013. Let's assume it's about that for 2018.

The standard deduction for a single person is $12,000, or 22.6% of MHI, and

the standard deduction for a married couple is $24,000 or 45.2% of MHI.

> To finance 80% of the median home in Portland, one would borrow about $250,000 at 4.5%. The first year interest payment would be about $11,000.
>
> So in 2018, qualified residence interest *might* be deductible if the taxpayer has other itemized deductions (anyone buying the median house in Portland almost certainly would), but it is not as obviously deductible as it was in 1986.



Form 1040 (1987) Page 2

Tax Computation

31 Amount from line 30 (adjusted gross income) . . . 31

32a Check if: ☐ **You** were 65 or over ☐ Blind; ☐ **Spouse** was 65 or over ☐ Blind.
Add the number of boxes checked and enter the total here . . . ▶ 32a

b If you can be claimed as a dependent on another person's return, check here . . ▶ 32b ☐

c If you are married filing a separate return and your spouse itemizes deductions, or you are a dual-status alien, see page 15 and check here . . . ▶ 32c ☐

33a **Itemized deductions.** See page 15 to see if you should itemize. If you don't itemize, enter zero. If you do itemize, attach Schedule A, enter the amount from Schedule A, line 26, **AND** skip line 33b . 33a

Caution: If you checked any box on line 32a, b, or c **and** you don't itemize, see page 16 for the amount to enter on line 33b.

b **Standard deduction.** Read **Caution** to left. If it applies, see page 16 for the amount to enter.
If **Caution** doesn't apply and your filing status from page 1 is: Single or Head of household, enter $2,540; Married filing jointly or Qualifying widow(er), enter $3,760; Married filing separately, enter $1,880 . 33b

34 Subtract line 33a **or** 33b, whichever applies, from line 31. Enter the result here . . . 34

35 Multiply $1,900 by the total number of exemptions claimed on line 6e or see chart on page 16 . . 35

36 **Taxable income.** Subtract line 35 from line 34. Enter the result (but not less than zero) . . . 36

Caution: If under age 14 and you have more than $1,000 of investment income, check here ▶☐ and see page 16 to see if you have to use Form 8615 to figure your tax.

37 Enter tax. Check if from ☐ Tax Table, ☐ Tax Rate Schedules, ☐ Schedule D, or ☐ Form 8615 37

38 Additional taxes (see page 16). Check if from ☐ Form 4970 or ☐ Form 4972 . . . 38

39 Add lines 37 and 38. Enter the total . . . ▶ 39

END OF HISTORY DETOUR

C. ELECTION to treat secured debt as NOT secured by a residence.

Taxpayers have always been able to elect out of residence interest treatment. The election was put in place when there was no dollar limit on qualified residence debt.

1.163-10T(o)(5) Election to treat debt as not secured by a qualified residence --

(i) In general. For purposes of this section, a taxpayer may elect to treat any debt that is secured by a qualified residence as not secured by the qualified residence. An election made under this paragraph shall be effective for the taxable year for which the election is made and for all subsequent taxable years unless revoked with the consent of the Commissioner.

Make the election by deducting the interest somewhere other than Schedule A line 10. (Can also attach a statement.)

The election must apply to the entire debt according to IRS Publication 936.

The election makes sense when there are several loans with different interest rates. Or when there is debt that could also qualify as some other kind of debt and the taxpayer wanted to apply the mortgage interest deduction to more debt.

George borrows $500,000 to purchase his house at 4.5%. A year later, he borrows $400,000 to substantially improve the house. The second loan is at 6%. He borrows a third time to improve the house even more and this time his interest rate is 5%. The third loan amount is $250,000. George has a total of $1,150,000 in debt secured by his residence.

When George shows up with his three 1098s, which ones count?

When making the election, the debt is allocated under the -8T regulations according to use of proceeds.

D. REPAYMENT

a) General order (for a mixed purpose loan). Under Treas. Reg. 1.163-8T(d)(1), debt is treated as repaid in this order:

1. Personal
2. Investment and Passive Activity (except number 3.)
3. Rental real estate with active participation
4. Former passive activities
5. Trade or business

b) First Allocated First Paid – If there is more than one expenditure in the same category, they are treated as repaid in the same order in which they were allocated.

c) Qualified Residence interest is “personal” interest under the -8T regs. So presumably rule b) applies to allocate repayment between personal and residence interest. However Pub. 936 has a mini set of ordering rules:

1. Home equity Debt
2. Grandfathered acquisition debt
3. Acquisition Debt

The publication needs to be updated. Home equity debt should be replaced with Personal.

E. REMINDER: REALLOCATION IS NECESSARY

Whenever loan proceeds are redeployed. AND whenever loans are repaid.

IMPORTANT: For formerly deductible home equity loans, ask taxpayer how proceeds were and are being used

Example:

1. Borrow $50K in 2012 and use $30K to buy a car and $20K for travel.
2. Sell car for $20K in 2016 and use funds to start a business.

The $20K of debt should be *reallocated* as business debt.

Same Example:

1. Borrow $50K in 2012 and use $30K to buy a car and $20K for travel.
2. Sell car for $20K in 2016 and use funds to start a business.
3. By 2018, perhaps taxpayer has paid off $25K.

The repayment rules apply to determine which part of the debt has been repaid.

Before 2018, we might have used the election in 10T(o) to NOT treat this as secured by a residence, which would have allowed taxpayer to borrow more and deduct interest.

Under -8T regs, this debt was all personal to start but was reallocated in 2016 to business and personal.

In 2016, the debt was $30K. At that time we would allocate 20K to business and 10K to personal.

In 2018, the debt is down to $23K. The repayment rules treat personal debt as paid first, and then business.

So in 2018, the debt is 20K business and 3K personal. We allocate the interest 20/23 to business and 3/23 to personal.

PART II. MORE PROBLEMS and EXAMPLES

A. Harley and Maddie.

Harley and Maddie purchased their $600,000 residence by paying 20% down, and financing the rest with a traditional 30-year mortgage for $480,000.

Several years later, the residence had appreciated to $800,000, and the couple took out a $150,000 home equity line to repay some outstanding credit card debt, and finance the last two years of college for their children. They deposited the $150,000 in a bank account from which they would make the credit card payments and pay tuition.

As it turned out, Maddie decided to use some of the HELOC money to expand her business by making a deposit on a larger office and investing in website design and search engine optimization.

<u>Discussion.</u>

Because the $480,000 original loan proceeds were used to acquire their primary residence, the debt is treated as acquisition indebtedness and the interest is deductible as qualified residence interest.

Because the proceeds of the HELOC were *not* used to acquire, build, or improve the primary residence, the $150,000 HELOC is not acquisition indebtedness. Under prior law, $100,000 of the HELOC could be treated as home equity indebtedness giving rise to deductible interest under IRC 163(h), but now only acquisition debt interest is deductible as qualified residence interest.

Notice, however that some of the proceeds were used for education. Consider IRC 221:

> (1)The term “qualified education loan” means any indebtedness incurred by the taxpayer solely to pay qualified higher education expenses— (A)which are incurred on behalf of the taxpayer, the taxpayer’s spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred, (B)which are paid or incurred within a reasonable period of time before or after the indebtedness is incurred, and (C)which are attributable to

education furnished during a period during which the recipient was an eligible student.

There are four kinds of debt here now:

Personal – repaying credit cards
Education
Business
Investment – the funds in the bank account

How do you allocate? How would you have allocated under prior law?

B. **Mort and his two or three mortgages**
(hat tip to Woody Warmoth, Portland Chapter OATC, for these examples)

1. Mort borrowed $550K to buy his house with FMV $800K. He then took out a second mortgage of $80K whose proceeds were used to start a business.

2. Mort borrowed $550K to buy his house with FMV $800K. He then took out a second mortgage of $200K whose proceeds were used to buy a new $60K car and $140K to start a business.

3. Mort borrowed $550K to buy his house with FMV $800K. He then took out a second mortgage of $150K whose proceeds were used to take a vacation $35K and $115K to start a business.

4. Mort borrowed $550K to buy his house with FMV $800K. He then took out a second mortgage of $100K whose proceeds were used to buy a new $30K car, $70K to start a business. Equity Line of credit with $60K balance used to replace windows $10K and $50K as down payment on rental.

5. Mort's home is free and clear. He just took out a new loan for $160K to pay bills of $30K, buy a classic car for $50K, and add an attached 3-car garage for $80K.

6. Mort's home is free and clear. He took out a new loan for $180K to buy a rental.

C. Mort's Reverse Mortgage

After an entire adult lifetime of buying $800,000 houses, Mort would now like to stop making mortgage payments. So he is considering a "Reverse Mortgage." His home is unencumbered and now has a value of about $2 Million (from the last appraisal for a refinancing).

Under the reverse mortgage, he would borrow $1 million which would be paid to him as an annuity for his life. The debt would be secured by the house, and when Mort dies, his estate will sell the house and repay the debt plus all of the interest.

D. Bruiser and his Repayments

Bruiser inherited a mansion worth $5 million with no mortgage. He borrowed $1 million (15 year term at 4.5%) on December 30, 2017, to add an Olympic size swimming pool and a fully equipped workout center and Zumba studio. In 2018 he will pay $44,000 in interest. He established a new bank account to hold the funds. In 2018 he will actually spend only $400,000 on the project.

> For 2018, how should Bruiser's loan be characterized?
>
> For 2018, how much is Bruiser's qualified residence interest deduction?

By the end of 2018, Bruiser had paid off $48,000 of the loan. The project was coming in under budget, so on April 1, 2019, he used $100,000 of the loan money in the account to have his business helicopter redecorated and custom painted by an artist.

> For 2019, how should Bruiser's loan be characterized?
>
> For 2019, how much of Bruiser's interest payments are deductible and for what reasons?

E. Examples from the Regs

There are some excellent and useful examples in the regulations (when the regs are up to date). Here are two examples. Some of the examples earlier were also from the regulations.

Example 1

B purchases a principal residence on January 1 for $800,000, making a down payment of $150,000 and borrowing Loan 1 of $650,000 secured by the residence. Six months later, B borrows Loan 2 of $300,000 secured by the residence to build an addition to the home. (Assume B had not made any principal payments on Loan 1 so the loan principal is still $650,000.)

- Both loans meet the definition for acquisition indebtedness because they are secured by the principal residence and were used to acquire, construct, or improve the residence.
- The total debt is $950,000, which exceeds the limitation for acquisition indebtedness
- How much of the interest on each loan is acquisition indebtedness?

Example 2: C borrows $100,000 on January 1 and opens a noninterest bearing checking account.

- April 1 Use 20,000 for a Passive Activity Expenditure
- September 1 Use $40,000 for a personal expenditure

Three time periods: Allocation:

Jan 1 – Mar 31	$100,000	investment
April 1 – Aug 31	20,000	Passive activity
	80,000	Investment
Sept 1 – Dec 31	20,000	Passive activity
	40,000	Personal
	40,000	Investment