

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

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to: Anne Ronholm  
(SBSE Technical Advisor, ATTI:TAG4)

from: Christopher F. Kane  
Branch Chief, Branch 3  
(Income Tax & Accounting)

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subject: Qualified Residence Interest Questions

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent. You have raised the following questions relating to section 1.163-10T of the Income Tax Regulations and the rules in Publication 936, Home Mortgage Interest Deduction.

**ISSUES**

Question 1. When a taxpayer has debt secured by a qualified residence but the debt exceeds the acquisition and/or home equity debt limitations, may the taxpayer use the exact method in section 1.163-10T(e) of the regulations to determine the amount deductible as qualified residence interest and trace the debt in excess of the limitations to underlying expenditures as described in section 1.163-10T(e)(4)?

Question 2. If a taxpayer may use the exact method, must an election also be made under section 1.163-10T(o)(5) to treat the debt as not secured by the qualified residence in order to trace debt that exceeds the limitation to its underlying expenditures?

Question 3: If a taxpayer uses the simplified method, may the taxpayer allocate excess interest under the interest tracing rules of section 1.163-8T without making an election under section 1.163-10T(o)(5) to treat the debt as not secured by a qualified residence?

## LAW AND ANALYSIS

### Background

Personal interest became nondeductible under section 163(h) as added by the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2246) (the 1986 Act). Section 163(h)(3) of the 1986 Act, however, permitted deduction of qualified residence interest. Section 163(h)(3) was amended by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987) to allow a deduction for qualified residence interest for up to \$1,000,000 of acquisition indebtedness and \$100,000 of home equity indebtedness. Prior to amendment, section 163(h)(3) generally permitted a deduction for qualified residence interest on indebtedness that did not exceed the basis of the residence and the cost of improvements, and on certain indebtedness incurred for medical and educational purposes.

Proposed and temporary regulations (sections 1.163-9T and 1.163-10T) were issued under section 163(h) on December 22, 1987, shortly before the statute was revised by OBRA 1987. Portions of these regulations relating to the limitations on the qualified residence interest deduction (i.e., indebtedness not in excess of basis increased by certain medical and educational debt) became obsolete when OBRA 1987 was enacted.

After the statute was changed, the Service issued Notice 88-74, 1988-2 C.B. 385, to provide guidance as to certain provisions of the revised statute. In addition, Publication 936, Home Mortgage Interest Deduction, was published to provide guidance with respect to the deduction.

The questions presented raise the issue of the extent to which the temporary regulations remain relevant to the calculation of qualified residence interest after the statutory changes. For example, although the limitation is now \$1,000,000 for acquisition indebtedness and \$100,000 for home equity indebtedness, rather than indebtedness not in excess of basis increased by certain medical and educational debt, the general methodologies provided in the regulations are still applicable, if modified to reflect the new limitations.<sup>1</sup>

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<sup>1</sup> For example, the regulations provided that average balances of indebtedness were to be used to figure the deduction (section 1.163-10T(h)), and provided guidance as to acceptable methods of determining average balances. In addition, the regulations define qualified residence (section 1.163-10T(p)) and secured indebtedness (section 1.163-10T(o)). Many of these rules are included in Publication 936.

### Section 1.163-10T Regulations: Simplified and Exact methods

The section 1.163-10T regulations provide two methods for determining a taxpayer's qualified residence interest when debt exceeds the applicable limitation; section 1.163-10T(d) describes a simplified method, and section 1.163-10T(e) describes an exact method. Under the simplified method, interest on all secured debts is multiplied by a fraction, the numerator of which is the adjusted purchase price of the qualified residence and the denominator of which is the sum of the average balances of all secured debts. Since enactment of OBRA 1987 the \$1,000,000 acquisition indebtedness limitation and the \$100,000 home equity indebtedness limitation must be substituted for the adjusted purchase price. When the simplified method is used, a taxpayer is required to treat interest on all excess debt as personal interest under the temporary regulations (section 1.163-10T(d)(2)).

Under the exact method, the amount of qualified residence interest is determined on a debt-by-debt basis by comparing the applicable debt limit for the debt to the average balance of each debt. The applicable debt limit is an amount that is different for each debt and is the lesser of the fair market value of the residence on the date the debt is secured and the adjusted purchase price of the qualified residence at the end of the taxable year, reduced by the average balance of each debt that was previously secured by the qualified residence. If the average balance of the debt does not exceed the limitation for that debt, all the interest on that debt is qualified residence interest. If the average balance of the debt exceeds the limitation, the amount of qualified residence interest is determined by multiplying the interest paid or accrued with respect to the debt by a fraction, the numerator of which is the applicable debt limit for that debt and the denominator of which is the average balance of the debt. Under the exact method, a taxpayer is permitted to treat interest on debt that exceeds the limitations according to the use of the debt proceeds under the interest tracing rules in section 1.163-8T.(section 1.163-10T(e)(4)).<sup>2</sup>

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<sup>2</sup> With the substitution of the new statutory limitations into the exact method described in section 1.163-10T(e), the regulations may be applied as modified by the statutory changes. For example, assume a taxpayer owns one qualified residence that secures the following debts incurred in this order:

First: \$900,000 acquisition debt

Second: \$250,000 home equity debt allocated to personal expenditures

Third: \$150,000 allocated to business expenditures

Under the new statutory limits, (1) the applicable debt limit for the first \$900,000 debt is \$1 million, all of the interest on which is deductible, (2) the applicable debt limit for the second \$250,000 debt is \$100,000, 10/25ths of the interest on which is deductible, and (3) the applicable debt limit for the third \$150,000 debt is 0 (\$100,000 reduced by the previous \$250,000 debt). However, since the third debt is allocable to business

### Legislative History

The legislative history to the OBRA 1987 changes discusses the allocation of interest in the House Committee Report to the Omnibus Budget Reconciliation Act of 1987, H.R. Rep. No. 100-391. At page 1033, the report states:

It is anticipated that the Internal Revenue Service will issue regulations describing the proper method for allocating interest on excess amounts of debt. In the interim until such regulations are issued, a reasonable method of allocation should be used. An example of a reasonable method of allocation is to ascertain which debt is the debt that exceeds the limitation by taking debt into account in the chronological order in which it was incurred or most recently refinanced, with the most recent debt (or portion thereof) treated as the amount of debt that exceeds the limit.

It is anticipated that the Internal Revenue Service will issue regulations describing the proper method for allocating interest on excess amounts of debt. In the interim until such regulations are issued, a reasonable method of allocation should be used.

### Publication 936

Publication 936 provides a worksheet that taxpayers may use to determine their qualified residence interest. The worksheet uses a method similar to the simplified method in section 1.163-10T(d) of the regulations. However, unlike section 1.163-10T(d), the instruction to line 13 of the worksheet in Publication 936 provides that the portion of secured indebtedness that is not qualified residence interest may be allocated in accordance with the use of the proceeds of the debt. The instruction states:

You cannot deduct the amount of interest on line 13 as home mortgage interest. If you did not use any of the proceeds of any mortgage included on line 9 of Table 1 for business, investment, or other deductible activities, then all the interest on line 13 is personal interest. Personal interest is not deductible.

If you did use all or part of any mortgage proceeds for business, investment or other deductible activities, the part of the interest on line 13 that is allocable to those activities can be deducted as business, investment, or other

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expenditures, interest on that debt would be deductible, regardless of whether the taxpayer had elected to treat the debt as not secured by the qualified residence, because under the exact method the taxpayer is permitted to treat interest that exceeds the limitation as traced to the particular expenditures for which the debt is used.

deductible expense, subject to any limits that apply....If you used the proceeds of the mortgages on line 9 for more than one activity, then you can allocate the interest on line 13 among the activities in any manner you select (up to the total amount of interest otherwise allocable to each activity, explained next).

Thus, under line 13 of the worksheet in Publication 936, interest on a secured debt that is allocated to a trade or business or other deductible activity and that exceeds the limitation for qualified residence interest may be deductible as a trade or business or other deductible expenditure.

### Election to treat debt as not secured by the qualified residence

The regulations under section 1.163-10T(o) and Publication 936 both state that taxpayers may make an election to treat a debt that is secured by a qualified residence as not secured by a qualified residence.<sup>3</sup> The election must apply to the entire indebtedness, and the election is made by reporting the interest on the return as business interest or other deductible interest rather than qualified residence interest. Late elections have been permitted under section 301.9100 of the regulations. A purpose of this election is to permit a debt that is allocable to trade or business expenses, and thus deductible without regard to the section 163(h) deduction, to not “use up” the limitation, thereby causing otherwise deductible debts to fail to qualify under the limitation. In addition, the election permits interest on the debt to qualify as an “above the line” deduction (i.e., deductible under section 62 as a deduction allowable in determining adjusted gross income) to the extent the debt is allocable to a trade or business or rental expenditure.

## CONCLUSIONS

### General principles

Since the legislative history states that until regulations are issued a reasonable method of allocating debt in excess of the limitation may be used, taxpayers may use any reasonable method, including the exact method and the simplified method described in the regulations, the method provided in Publication 936 (similar to the simplified method in the regulations) or a reasonable approximation of those methods.

Question 1. May a taxpayer use the exact method in section 1.163-10T(e) to determine the amount deductible as qualified residence interest when the taxpayer has debt that is secured by a qualified residence but the debt exceeds the acquisition and/or home equity debt limitations?

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<sup>3</sup> Section 1.163-10T(o)(5) states, “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.”

Conclusion: A taxpayer may use any reasonable method, including the exact method, to determine the amount deductible as qualified residence interest when debt exceeds the acquisition and/or home equity debt limitations. Regardless of which reasonable method is used, a taxpayer may allocate the amounts that exceed the limitations in accordance with the use of the debt proceeds, as provided in section 1.163-10T(e)(4) and the instructions to line 13 of Publication 936.

Question 2. If a taxpayer may use the exact method, must the taxpayer elect under section 1.163-10T(o)(5) to treat the debt as not secured by the qualified residence in order to allocate the interest on the part of the debt that exceeds the qualified residence interest limitations according to the use of the proceeds as provided in section 1.163-8T?

Conclusion: A taxpayer using the exact method, or any other reasonable method, is not required to make the election under section 1.163-10T(o)(5) in order to allocate the interest on the part of the debt that exceeds the qualified residence interest limitations under section 1.163-8T. The election under section 1.163-10T(o)(5) applies only to the whole amount of a debt and not to part. When the election is made under section 1.163-10T(o)(5), the entire debt is treated as not secured by the residence; when the election is not made, only the portion of the debt that exceeds the limitation is traced according to the use of the debt proceeds.

Question 3. If a taxpayer uses the simplified method, may the taxpayer allocate excess interest under the interest tracing rules of section 1.163-8T without making an election under section 1.163-10(o)(5) to treat the debt as not secured by a qualified residence?

Conclusion. A taxpayer using the simplified method may allocate excess interest under the interest tracing rules of section 1.163-8T, as described in the instruction to line 13 of the worksheet in Publication 936, without making an election under section 1.163-10T(o)(5). The method provided for in Publication 936 is another reasonable method allowed by the legislative history.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Temporary or final regulations pertaining to one or more of the issues addressed in this memorandum have not yet been adopted. Therefore, this memorandum will be modified or revoked by the adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusion in the memorandum.

Please call (202) 622-4950 if you have any further questions.

cc: Samuel Berman, Special Counsel  
Office of Division Counsel, Small Business/Self Employed