POINT & COUNTERPOINT

CCA 200911007 and the $1 Million Mortgage Interest Deduction Ceiling

Section 163(h)(3) allows taxpayers to deduct interest on acquisition indebtedness while section 163(h)(3)(B)(ii) provides that "[t]he aggregate amount treated as acquisition indebtedness shall not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return)."

In Chief Counsel Advisory (CCA) 200911007 (Mar. 3, 2009), the Service addressed the amount of interest that was deductible as "qualified residence interest" under section 163(h)(3)(A) when a residence encumbered by a purchase money mortgage of more than $1,000,000 is co-owned by two unmarried taxpayers both of whom are obligated on the mortgage and for both of whom the residence is the principal residence. The Service concluded:

> Under § 163(h)(3)(B)(i), acquisition indebtedness is defined, in relevant part, as indebtedness incurred in acquiring a qualified residence of the taxpayer – not as indebtedness incurred in acquiring taxpayer's portion of a qualified residence. The entire amount of indebtedness incurred in acquiring the qualified residence constitutes "acquisition indebtedness" under § 163(h)(3)(A)(i). In this case, the amount of indebtedness incurred in acquiring [the residence] exceeds $1,000,000. However, under § 163(h)(3)(B)(ii), the amount treated as acquisition indebtedness for purposes of the qualified residence interest deduction is limited to $1,000,000 of total, "aggregate" acquisition indebtedness. This is evident from the parenthetical in § 163(h)(3)(B)(ii) which limits the aggregate treated as acquisition indebtedness to $500,000 for a married taxpayer filing a separate return.

Professor Patricia Cain argues that the CCA was wrongly decided and that the $1,000,000 ceiling should be applied on a "per taxpayer" basis. Professor Martin McMahon argues that the $1,000,000 ceiling on acquisition indebtedness applies both on a residence-by-residence and taxpayer-by-taxpayer basis.

NewsQuarterly encourages readers to submit responses or comments which may be published in a subsequent issue.
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POINT

CCA 200911007 and the $1,000,000 Limitation on Mortgage Interest Deductions: Two Wrongs Don't Make a Right

By Patricia A. Cain*

Two unmarried taxpayers co-own their principal residence. They are both liable on the $2,000,000 purchase-money mortgage. They split the monthly payments equally so that each owner pays interest on a total of half of the mortgage. Each claims an interest deduction for 100% of the interest that each owner paid on $1,000,000 of acquisition indebtedness. In CCA 200911007, the Office of Chief Counsel advised that the deductions claimed by the two unmarried taxpayers are improper. Because the total acquisition debt on their residence exceeds $1,000,000, they should be limited, between them, to interest paid on $1,000,000.

Under the CCA, the Service will apply the $1,000,000 ceiling on debt that may be treated as "acquisition indebtedness" on a "per residence" basis. By contrast, I believe the only sensible way to apply the ceiling is on a "per taxpayer" basis. The fact that married taxpayers are limited to a ceiling of $1,000,000 between them is not sufficient reason to limit two (or more) unrelated, unmarried taxpayers who co-purchase a residence to a single ceiling of $1,000,000.

The problem arises because of an inartfully drafted statute. In 1986, Congress repealed the deduction for personal interest generally, but preserved the deduction for qualified residence interest. In 1986, no dollar maximums were placed on the amount of "qualified residence interest" that could be deducted. Taxpayers could deduct 100% of all acquisition debt, as well as 100% of any home equity debt that was used for qualified medical or educational expenses, provided the aggregate amount of such indebtedness did not exceed "the lesser

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of" either "the fair market value of [the] qualified residence" or "the sum of … *the taxpayer's basis* in [the] qualified residence … plus … [t]he aggregate amount of *qualified indebtedness of the taxpayer* with respect to [the] qualified residence." I.R.C. § 163(h)(3)(B) (emphasis added) as originally enacted by the Tax Reform Act of 1986.

The clear referent for determining the limitation in 1986 was the taxpayer. Each taxpayer's limit was to be computed by reference to the lesser of the fair market value of the *taxpayer's* residence or the *taxpayer's* basis in that residence. The fair market value limitation was enacted to ensure that no taxpayer could deduct mortgage interest on aggregate debt that exceeded the property's fair market value. The only sensible way to apply this limit in cases involving multiple ownership would have been to consider each taxpayer's fair market value and basis, rather than aggregate fair market value, indebtedness, or basis. For example, if taxpayer A had purchased a home in 1986 for $3,000,000, incurring a mortgage liability of $2,000,000, and then had sold a 50% interest in the home to a cohabitant, taxpayer B, for $1,500,000 in cash, how would we measure A's limit—by his individual basis in his half or by aggregate basis? Should the fair market value limitation be the fair market value of the property or the fair market value of his individual share? The most reasonable answer is that he should be limited to interest deductions on $1,500,000 of the $2,000,000 mortgage debt because that is his individual basis. The limit is applied per taxpayer because Congress did not want to give any taxpayer an interest deduction on mortgage debts that exceeded the fair market value of what the taxpayer owned. Nor did Congress want to authorize deductions on mortgages in excess of basis except in the case of qualified home equity indebtedness, which had to be used to pay educational or medical expenses.

The changes made in 1987 retain the underlying principle of the 1986 statute by limiting the amount of the deduction to "acquisition indebtedness," which will almost always be no more than the fair market value of the property, plus a limited amount of home equity indebtedness ($100,000 maximum). The 1987 statute provides an additional limit: acquisition indebtedness cannot exceed $1,000,000. Since the 1986 limitation applied "per taxpayer" and not "per residence," it is reasonable to conclude that the 1987 limitation of $1,000,000 should also be applied "per taxpayer." The only reason given for the $1,000,000 limitation was "to limit the benefits of the interest deductions in the case of high-income persons." H.R. Rep. No. 100-391 (II), as reprinted in 1987 U.S.C.C.A.N 2313-378, 2313-648. This statement suggests that the limit was intended to be applied "per person" and not "per residence."

The Service supports its construction of the statute by claiming that "acquisition indebtedness" is debt incurred to acquire a "residence" and not a "portion of a residence." Yet, in determining which residences qualify under section163(h)(3), the statute refers to section 121, a provision which clearly treats a co-tenant's interest in a residence as a residence. Furthermore, the only regulations that have ever been drafted under section 163(h)(3) provide that jointly-owned property under a time-sharing arrangement will qualify as a personal residence of the taxpayer. *See* Treas. Reg. § 1.163-10T(p)(6). The portion of the residence that will qualify is the taxpayer's time portion. Thus, a taxpayer who borrows $1,000,000 to purchase three months out of twelve months of a time-share vacation home appears to have a qualified acquisition debt of $1,000,000 regardless of how much additional acquisition debt is outstanding on the entire residence. In this case, the $1,000,000 limitation is applied "per taxpayer" rather than "per residence."

Housing prices in the San Francisco area are so high that many first-time home buyers cannot afford to enter the market for single homes. It is becoming a common practice for unmarried taxpayers to purchase a home together, sharing the liability for the mortgage payments in proportion to their ownership interests. The practice has become common enough that an entire real estate market has developed, offering tenancy in common ownership (TICs) in homes that either have separate units or can be adapted to provide separate living spaces. TIC purchasers typically assume a portion of a pre-existing acquisition debt that often exceeds $1,000,000, although a few banks have begun to offer separate financing for TIC purchases. The mere fact that people cannot afford to buy the homes that they want unless they can share the cost with others should not prevent them from claiming an interest deduction on the portion of the mortgage they can afford to pay. Yet, if the aggregate acquisition debt exceeds $1,000,000, the CCA would appear to limit the deductions of individual taxpayers.

The rules in section 163(h) do create a marriage penalty. The parenthetical in section 163(h)(3)(B)(ii) limits acquisition debt for married individuals who file separately to $500,000. The statute is silent as to the limit that applies to married couples who file jointly. However, in 2001, the Service concluded "that Congress did not intend to treat married couples filing jointly differently than married couples filing separately." FSA 200137033 (Sept. 14, 2001). As a result, the maximum amount of acquisition indebtedness on which a married couple can claim interest deductions is $1,000,000. (A similar rule applies to the $100,000 limit for home equity indebtedness.)

There is one additional marriage penalty in section 163(h)(4). Each taxpayer is entitled to interest deductions on qualified debt incurred on a principal residence and one other personal residence. The statute provides that married taxpayers who file separately shall be treated as one taxpayer with respect to this rule. Thus, between them they can only claim interest deductions on indebtedness secured by a maximum of two homes. FSA 200137033

extends this two-home limit to married taxpayers who file jointly.

In each of the following examples illustrating the marriage penalties, A and B are initially unmarried:

- A and B each owns a principal residence and one additional home, with $500,000 of acquisition debt outstanding on each of the four homes. They each can deduct 100% of the interest they pay. But the moment they marry, they will become limited to interest deductions on only two of the homes and on a maximum of $1,000,000 out of the $2,000,000 of their aggregate acquisition indebtedness.
- A and B each owns a principal residence with $1,000,000 of acquisition debt outstanding on each residence. They each can deduct 100% of the interest they pay. But the moment they marry, their combined interest deductions will be cut in half because, as spouses, they will be limited to aggregate acquisition debt of $1,000,000 between them.
- As in the CCA, A and B co-purchase a single residence, with each of them borrowing $1,000,000 to acquire their interest. If the $1,000,000 limitation is applied "per taxpayer," as I believe it should be, each taxpayer will be entitled to deduct 100% of the interest paid. But the moment they marry, they will be treated as one taxpayer, limited to $1,000,000 of acquisition debt between them.

By construing section 163(h)(3) to provide a $1,000,000 ceiling "per residence," the Service has removed the marriage penalty in the third example, but not in the first two. The marriage penalty is built into the entire statute because Congress elected to treat all married couples the same. This principle of marriage equality became a basic principle in our tax law when Congress adopted joint returns in 1948. It often produces marriage penalties for two-earner couples by treating them the same as one-earner couples. Since a married couple that consists of only one taxpayer (i.e., one earner and one dependent spouse) would be limited to $1,000,000 of acquisition indebtedness (and two residences), the principle of marriage equality would require imposition of the same limits on a two-taxpayer married couple.

The best explanation for the Service position in the CCA is a concern about the marriage penalty. But adopting a "per residence" limit for the $1,000,000 ceiling on acquisition debt is not the right way to remedy that concern. If it is wrong to have a marriage penalty in section 163(h)(3), then Congress ought to remedy the problem directly by considering the larger policy question of how two taxpayers, married to each other, ought to be treated compared to (1) a taxpayer who is married to a dependent, non-taxpayer spouse; and (2) two unmarried taxpayers. If the section 163 marriage penalty is wrong, it does not make it right to extend the rule that creates the penalty to unmarried taxpayers who, for whatever reason, co-purchase a principal residence. Two wrongs do not make a right.

COUNTERPOINT

CCA 200911007: Trying to Make Sense of the $1,000,000 Ceiling in the Home Mortgage Interest Deduction Rules

By Martin J. McMahon, Jr.*

Many commentators in the debate on the rectitude of CCA 200911007 have described the CCA as holding that the $1,000,000 limitation on the deduction of mortgage interest on acquisition indebtedness under section 163(h)(3)(B) applies on a per-mortgage basis. Some of the commentators have asserted that, prior to the issuance of this CCA, there was a general assumption that unmarried co-owners could each deduct mortgage interest on $1,000,000 of acquisition indebtedness, thus permitting deduction of interest on a $2,000,000 mortgage on a home they owned in common and that the CCA is wrong. They have taken this position notwithstanding the conventional wisdom for the twenty some years since the present version of section 163(h)(3) was adopted in the 1987 amendments to section 163(h) that a married couple filing a joint return was entitled to deduct interest on only $1,000,000 of acquisition indebtedness. (Nevertheless, in administering section 163(h), Service guidance states that "debt you incurred to buy, build, or substantially improve your home, to the extent that it is more than the home acquisition debt limit, may qualify as home equity debt." Publication 936, *Home Mortgage Interest Deduction* 9 (2008). This interpretation allows a deduction for interest on a purchase money mortgage of up to $1.1 million.)

I disagree with the commentators who have so described the holding of CCA 200911007 and who have criticized it as an incorrect interpretation of the statute. I read the CCA to hold that the $1,000,000 ceiling on "acquisition indebtedness," as defined in section 163(h)(3)(B), applies on *both* a residence-by-residence basis and a taxpayer-by-taxpayer basis.

The CCA addressed the tax consequences of only one of the co-owners—the one who originally owned the property in fee simple and was solely obligated on the mortgage and who subsequently conveyed an undivided ownership interest to a second person who also became obligated on the

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mortgage. The CCA concluded that under the formula in Regulation section 1.163-10T(e), the interest deductible by the taxpayer in question was to be determined by multiplying the amount of interest paid by a fraction, the numerator of which is $1,000,000 and the denominator of which is the amount of the mortgage. If, for example, the mortgage was $1,500,000 and the taxpayer paid $75,000 of interest, the amount of the taxpayer's interest deduction would be $50,000 ($75,000 x ($1,000,000 ÷ $1,500,000)). This formula should work, because if one of several jointly obligated joint owners of property pays more than a ratable share of otherwise deductible interest, a deduction is allowable for the full amount paid. *See Mason v. United States*, 453 F. Supp. 845 (N.D. Cal. 1978); *Finney v. Commissioner*, 35 T.C.M. (CCH) 1504 (1976).

There is a good argument that the reasoning and conclusion of the CCA limiting to $1,000,000 the amount of "acquisition indebtedness" that can be taken into account collectively by all of the owners of the residence is correct. The legislative history (H.R. Rep. No. 100-391 (II), at 1031-34 (1987); H.R. Rep. No. 100-495, at 916-17 (1987) (Conf. Rep.)) provides no useful guidance, but a careful reading of the statutory language indicates that because section 163(h)(3)(B)(ii) omits any reference to a "taxpayer," it limits to $1,000,000 the aggregate amount of "acquisition indebtedness" that may be taken into account in determining the amount of "qualified residence interest" with respect to all of the taxpayers that might reside in that dwelling unit.

Section 163(h)(2)(D) and (3)(A) excepts from the general rule of section 163(h)(1) disallowing a deduction for personal interest, "qualified residence interest." "Qualified residence interest" is defined in section 163(h)(3)(A) to mean "acquisition indebtedness with respect to any qualified residence of the taxpayer," and certain home equity indebtedness. Section 163(h)(3)(B)(i) in turn defines "acquisition indebtedness" as "indebtedness which ... is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and ... is secured by such residence." But section 163(h)(3)(B)(ii) provides that "[t]he aggregate amount treated as acquisition indebtedness for any period shall not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return)."

If the $1,000,000 ceiling does not apply on both a residence-by-residence and a taxpayer-by-taxpayer basis, and each taxpayer who resides in the residence is an owner and is obligated on the "acquisition indebtedness" mortgage is entitled to deduct interest paid on up to $1,000,000 of acquisition indebtedness, then on a joint return each of the husband and wife would be entitled to deduct interest on up to $1,000,000 of "acquisition indebtedness." That is true because notwithstanding the filing of a joint return, a husband and wife are separate and distinct taxpayers. *See, e.g.*, *Frahm v Commissioner*, 94 T.C.M. (CCH) 504 (2007). But the statute clearly does not contemplate that result, as evidenced by the limitation on the deduction to the interest on $500,000 of acquisition indebtedness by married taxpayers who file separately. The parenthetical indicates, even though it does not expressly state, that a husband and wife who each own a one-half interest in the residence and are jointly and severally liable on the mortgage can deduct interest on only $1,000,000 of acquisition indebtedness. Furthermore, in *Pau v. Commissioner*, 73 T.C.M. (CCH) 1819 (1997), the Tax Court held that a married couple filing jointly was entitled to deduct only the interest attributable to $1,000,000 of an acquisition loan, the outstanding principal balance of which was $1,330,000. Thus, the only precedent as of now holds that a husband and wife are not each allowed separately to deduct interest on up to $1,000,000 of acquisition indebtedness where total acquisition indebtedness of their joint principal residence exceeds $1,000,000. (Concededly, it does not appear that the taxpayers in *Pau* argued that each of the husband and wife were entitled to deduct interest on up to $1,000,000 of acquisition indebtedness.) An interpretation of the statute that applies the $1,000,000 ceiling on "acquisition indebtedness," as defined in section 163(h)(3)(B), on both a residence-by-residence and a taxpayer-by-taxpayer basis avoids this "marriage penalty" that would otherwise arise.

Some have proffered the argument that the cross reference to section 121 in section 163(h)(4) for the definition of a "principal residence" incorporates the provisions of Regulation section 1.121-2(a)(2), applying the $250,000 exclusion on a per-taxpayer basis in a co-owner situation. This argument should not carry any weight whatsoever. The cross reference does not incorporate calculational methodology, but merely the definition of principal residence. When section 163(h) was enacted in 1986, and the relevant amendments adopted in 1987, former section 1034 provided rollover for gains on the sale of a principal residence. With the enactment of section 121 in 1997, section 163(h) was amended just to change the cross reference from section 1034 to section 121. The only purpose of the cross reference is to invoke rules for distinguishing a "principal residence" from a "secondary residence."

Section 163(h)(4)(A) "treats" a husband and wife filing separate returns as a "single taxpayer" for purposes of determining the number of qualified residences and limits them collectively to two residences. I don't think the parenthetical in section 163(h)(4)(A) can by inference convert a husband and wife into a single taxpayer if they do not file a separate return. Core doctrinal tax law is that husband and wife, even if they file a joint return, are two separate and distinct taxpayers whose items are aggregated. Various Code sections, such as sections 267 and 1041, can alter the timing and recognition rules, etc., but

they are overrides. Various Code sections can expressly provide an allowance, ceiling, or floor on a particular item on joint returns that differs from double that on returns of single taxpayers, but they are all express, not inferred. Section 163(h)(4)(A), coupled with the parentheticals in section 163(h)(3)(B)(ii) and 163(h)(3)(C)(ii) can as easily, maybe more easily, be read as an express penalty on married taxpayers who file separate returns.

It is possible that the origin of the difficultly in interpreting the statutory language very well might lie in the drafters of the 1987 amendment to section 163(h) erroneously believing that married individuals filing a joint return as a matter of doctrinal law were converted into one unitary taxpayer. That is incorrect, but the same error led to some strange language in section 121(d)(1) that is discussed in an article I published shortly after section 121 was enacted. *See* Martin J. McMahon, Jr., *Taxation of Sales of Principal Residences After the Taxpayer Relief Act of 1997*, 75 TAXES 610 (Nov. 1997). It is also possible that the drafters of section 163(h)(3) might have failed to contemplate the fact pattern in the CCA. In 1987, these issues had been little discussed by tax professionals, with the exception of some in academia, and if the discussion was only in a mainstream law review, no one writing the statutory language was aware of it.

Thus we are forced to try to figure out the meaning of statutory language that very well might have been drafted on an erroneous premise regarding the default meaning of the word "taxpayer" in a Code provision, and which possibly never contemplated two single taxpayers co-owning a home with a purchase money mortgage. In the end, I think the words of the statute are better construed to mean that the $1,000,000 ceiling is both per physical residence unit and per taxpayer, than to mean that the statute creates a marriage penalty when two singles who co-own a principal residence with a $2,000,000 purchase money mortgage get married and file a joint return, thereby losing one-half of their interest deduction because the joint return is limited to interest on a $1,000,000 mortgage. Construing the statute to allow a husband and wife on a joint return to claim deductions for interest on a $2,000,000 mortgage but allowing them a deduction on only a $1,000,000 mortgage if they file separately is the least likely plausible construction.

There is one conclusion of which I am certain. It is inconceivable that Congress intended to allow two unmarried taxpayers who share a principle residence each to deduct interest on acquisition indebtedness of up to $1,000,000, for a total of $2,000,000 of acquisition indebtedness, while limiting married couples filing jointly to a deduction for interest on acquisition indebtedness of up to only $1,000,000. Unless the statutory language unambiguously compels that result, any interpretation of the statute that reaches that result is likely to be rejected by the courts. Thus, the most reasonable conclusion is that if challenged, the Service's conclusion in CCA 200911007 likely will be sustained. ■

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Our analysis shows horizontal equity cannot be classified by region, i.e., we cannot say the Northeast is more/less equitable than the Southwest. However, considering taxpayers who own homes, we observe the states that are the most inequitable tend to be in the coastal areas. Likely, this is a reflection of the cost of living disparities between areas within the state. The states where renters have the most inequity are more scattered. Interestingly, there are only eight states whose Coefficient of Variation Ratio (the measure we used for HE) for this group of taxpayers is above the federal average (i.e., has worse horizontal equity) for both owners and renters: California, Colorado, Florida, Hawaii, Montana, New York, North Dakota, and Vermont.

In a perfect HE world, the United States would be economically homogeneous within income bands. Of course, this is not the case. The size and diversity of the United States is arbitrary and changes over time, yet the Code applies the same law to everyone regardless of location. Changes in tax prices, like all prices, are caused in part by changes in space (geography) and time (inflation). Congress has been much more aggressive addressing the inequities caused by inflation. They have, for the most part, neglected the very real inequities caused by geographical differences within the United States.

Policy recommendations must be weighed against increases in complexity and compliance burdens. One fairly easy way to eliminate some of this inequity is to create different federal income tax brackets for each state or city that would take into account the federal tax subsidy due to, for example, housing cost differences. We anticipate that different tax rate schedules would be needed for different taxpayers (e.g., itemizers vs. non-itemizers or renters vs. homeowners) for a particular location, which would add some complexity (and possible political problems) and may create new tax avoidance schemes. For those states that have a tax system that is derived from federal tax law, this change could prove problematic.

Another possibility would be to eliminate the mortgage interest, property tax, and state income tax deductions for all taxpayers, if these variables are causing variances in horizontal equity, while