Chief Counsel Advice Memoranda 200940030

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ISSUE

Whether indebtedness that is incurred by a taxpayer to acquire, construct, or substantially improve a qualified residence can constitute "home equity indebtedness" (within the meaning of § 163(h)(3)(C)) to the extent it exceeds $1 million.

CONCLUSION

Indebtedness incurred by a taxpayer to acquire, construct, or substantially improve a qualified residence can constitute home equity indebtedness to the extent it exceeds $1 million (subject to the $100,000 and fair market value limitations imposed on home equity indebtedness by § 163(h)(3)(C)).

BACKGROUND

The law allows taxpayers to deduct interest on two categories of indebtedness secured by their residences: acquisition indebtedness and home equity indebtedness. Acquisition indebtedness is indebtedness to acquire, construct, or substantially improve a residence, but the amount treated as acquisition indebtedness cannot exceed $1 million. Home equity indebtedness is indebtedness other than acquisition indebtedness, but the amount treated as home equity indebtedness cannot exceed $100,000.

You pose the following situation: Taxpayer buys a principal residence for $1,500,000, paying $200,000 in cash and borrowing the remaining $1,300,000 through a loan that is secured by the residence. You ask whether $100,000 of Taxpayer's indebtedness in excess of $1 million can qualify as home equity indebtedness. If so, interest on up to $1.1 million of the debt would be deductible ($1 million of acquisition indebtedness and $100,000 of home equity indebtedness). Because home equity indebtedness is defined in § 163(h)(3)(C) as debt other than acquisition

indebtedness, the resolution of the issue depends upon the definition of "acquisition indebtedness."

LAW AND ANALYSIS

Statutory provisions

Section 163(h)(1) provides that, in the case of a taxpayer other than a corporation, no deduction shall be allowed for personal interest. Section 163(h)(2) defines personal interest as "any interest allowable as a deduction ... other than ...", inter alia, qualified residence interest (§ 163(h)(2)(D)). Section 163(h)(3)(A) defines "qualified residence interest" to include interest on "acquisition indebtedness" and "home equity indebtedness."

Section 163 (h)(3)(B) and (C) define acquisition indebtedness and home equity indebtedness as follows:

(B) Acquisition Indebtedness.

(i) In general. The term "acquisition indebtedness" means any indebtedness which-

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

(II) is secured by such residence. Such term also includes any indebtedness ... resulting from the refinancing ...

(ii) $1,000,000 limitation. The 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).

(C) Home Equity Indebtedness.

(i) In general. The term "home equity indebtedness" means any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent the aggregate amount of such indebtedness does not exceed -

(I) the fair market value of such qualified residence, reduced by

(II) the amount of acquisition indebtedness with respect to such residence.

(ii) Limitation. The aggregate amount treated as home equity indebtedness for any period shall not exceed $100,000 ($50,000 in the case of a separate return by a married individual).

We see two possible interpretations of the definition of acquisition indebtedness. Under the first interpretation, acquisition indebtedness means all indebtedness, regardless of amount, incurred to acquire, construct, or substantially improve a qualified residence. That is, under this interpretation, the $1 million limitation in § 163(h)(3)(B)(ii) is not an element of the definition of

acquisition indebtedness, but is a separate limitation on deductibility. If this interpretation is correct, then a taxpayer who borrows in excess of $1 million to acquire, construct, or substantially improve a qualified residence may not treat the excess above $1 million as home equity indebtedness, because that amount, even though in excess of $1 million, remains acquisition indebtedness.

Under the second interpretation, the $1 million limitation in § 163(h)(3)(B)(ii) is an element of the definition of acquisition indebtedness, so that indebtedness that otherwise qualifies as acquisition indebtedness fails to qualify to the extent it exceeds $1 million. If this interpretation is correct, then a taxpayer who borrows in excess of $1 million to acquire, construct, or substantially improve a qualified residence may treat the excess above $1 million as home equity indebtedness, because that amount by definition does not constitute acquisition indebtedness.

We think the second interpretation is the better interpretation. We read the definition of "acquisition indebtedness" in § 163(h)(3)(B) as including both the § 163(h)(3)(B)(i) and § 163(h)(3)(B)(ii) elements. As discussed below, we think this interpretation comports with how the term "acquisition indebtedness" is used in other sections of the Code.

Use of the term "acquisition indebtedness" in § 163 (h) (3) (A)

Section 163(h)(3)(A) defines qualified residence interest as interest paid or accrued during the taxable year on acquisition indebtedness or home equity indebtedness with respect to any qualified residence of the taxpayer. Since qualified residence interest is intended to be interest that is deductible, to define acquisition indebtedness or home equity indebtedness without regard to the $1,000,000 and $100,000 limitations would arguably render the statute meaningless. The term "acquisition indebtedness," as used in § 163(h)(3)(A) must mean indebtedness incurred to acquire, construct, or substantially improve the qualified residence that does not exceed the $1,000,000 limitation. Similarly, the term "home equity indebtedness," as used in § 163(h)(3)(A) must mean indebtedness that does not exceed the $100,000 limitation.

Use of the term "acquisition indebtedness" in § 108

Section 108 adopts a definition of acquisition indebtedness provided by § 163(h)(3)(B) that is consistent with defining acquisition indebtedness by reference to both § 163(h)(3)(B)(i) and (ii). Sections 108 (a)(1)(E) and 108(h) provide an exclusion for the discharge of indebtedness on a taxpayer's qualified principal residence. In doing so, § 108(h) adopts and modifies the definition of acquisition indebtedness found in § 163(h)(3)(B) to determine what indebtedness qualifies for the exclusion.

Section 108(h)(2) reads as follows:

> Qualified principal residence indebtedness. For purposes of this section, the term "qualified principal residence indebtedness" means acquisition indebtedness (within the meaning of § 163(h)(3)(B), applied by substituting "$2,000,000 ($1,000,000" for "$1,000,000 ($500,000" in clause (ii) thereof) with respect to the principal residence of the taxpayer.

Importantly, § 108(h)(2) does not adopt the definition of acquisition indebtedness provided by § 163 (h)(3)(B)(i) and then simply apply a $2 million limitation on the exclusion. Instead,

recognizing that the $1 million limitation in § 163(h)(3)(B)(ii) is incorporated in the definition of the term "acquisition indebtedness," § 108(h)(2) modifies the dollar amount defining the term. Therefore, the debt treated as acquisition indebtedness under § 163(h)(3)(B) is only the first $1 million of debt used to acquire, construct, or substantially improve a qualified residence. If acquisition indebtedness was instead defined to include all debt used to acquire, construct, or substantially improve a qualified residence, it would not be necessary for § 108 (h) (2) to modify the definition of acquisition indebtedness. Instead, it would suffice simply to state that acquisition indebtedness, limited to $2 million, is eligible for exclusion.

Use of the term "acquisition indebtedness" in § 56 (e)

The alternative minimum tax provisions also refer to § 163(h) in § 56(e) of the Code, and also suggest that the definition of acquisition indebtedness in § 163(h)(3)(B) incorporates the $1 million limitation in § 163(h)(3)(B)(ii). Section 56 (b) allows a deduction for qualified housing interest, as defined in § 56(e). Section 56(e) defines qualified housing interest as interest which is qualified residence interest under § 163(h)(3) (i.e., interest paid on acquisition indebtedness and home equity indebtedness) and is paid or accrued during the taxable year on indebtedness which is incurred in acquiring, constructing, or substantially improving any property which is the principal residence of the taxpayer or is a qualified dwelling which is a qualified residence of the taxpayer.

If the $1 million limitation on acquisition indebtedness is not part of the definition of acquisition indebtedness in § 163(h)(3)(B), then arguably interest on acquisition indebtedness is deductible for AMT purposes without limitation. Since that result plainly was not contemplated by Congress, it is more consistent with the statutory scheme to define acquisition indebtedness by reference to both §§ 163(h)(3)(B)(i) and (ii).

CONCLUSION

Indebtedness that is incurred to acquire, construct or substantially improve a residence, thus satisfying § 163(h)(3)(B)(i), but that exceeds $1,000,000, so not satisfying § 163(h)(3)(B)(ii), is not acquisition indebtedness. Therefore, home equity indebtedness, as defined in § 163(h)(3)(C) includes indebtedness incurred to acquire, construct or substantially improve a qualified residence, to the extent that the indebtedness exceeds the $1 million limit on acquisition indebtedness and to the extent the other requirements of § 163(h)(3)(C) are satisfied.

We recognize that the position taken in this memorandum is inconsistent with Pau v. Commissioner, T.C. Memo. 1997-43 and Catalano v. Commissioner, T.C. Memo. 2000-82, regarding the definition of acquisition indebtedness in § 163(h)(3)(B). However, we believe that the position in this memorandum is the better interpretation of § 163(h)(3)(B) and (C).

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