



Tax Reduction Letter

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Revenue Ruling 2010-25

Interest

ISSUE

Limitations on qualified residence interest. This ruling holds that indebtedness in excess of \$1 million that a taxpayer incurs to acquire, construct, or substantially improve a qualified residence may constitute home equity indebtedness within the meaning of *section 163(h)(3)(C)* of the Code.

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) of the Internal Revenue Code*) to the extent it exceeds \$1 million.

FACTS

In 2009, an unmarried individual (Taxpayer) purchased a principal residence for its fair market value of \$1,500,000. Taxpayer paid \$300,000 and financed the remainder by borrowing \$1,200,000 through a loan that is secured by the residence. In 2009, Taxpayer paid interest that accrued on the indebtedness during that year. Taxpayer has no other debt secured by the residence.

LAW

Section 163 (a) allows as a deduction all interest paid or accrued within the taxable year on indebtedness. However, for individuals *§ 163 (h) (1)* disallows a deduction for personal interest. Under *§ 163 (h) (2) (D)*, qualified residence interest is not personal interest. *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 secured by any qualified residence of the taxpayer. Under *§ 163 (h) (4) (A)*, "qualified [*2] residence" means a taxpayer's principal residence, within the meaning of *§ 121*, and one other residence selected and used by the taxpayer as a residence.

Section 163 (h) (3) (B) (i) provides that acquisition indebtedness is any indebtedness that is incurred in acquiring, constructing, or substantially improving a qualified residence and is secured by the residence. However, *§ 163 (h) (3) (B) (ii)* limits the amount of indebtedness treated as acquisition indebtedness to \$1,000,000 (\$500,000 for a married individual filing separately). Accordingly, any indebtedness described in *§ 163 (h) (3) (B) (i)* in excess of \$1,000,000 is, by definition, not acquisition indebtedness for purposes of *§ 163 (h) (3)*.

Section 163 (h) (3) (C) (i) provides that home equity indebtedness is any indebtedness secured by a qualified residence other than acquisition indebtedness, to the extent the fair market value of the qualified residence exceeds the amount of acquisition indebtedness on the residence. However, *§ 163 (h) (3) (C) (ii)* limits the amount of indebtedness treated as home equity indebtedness to \$100,000 (\$50,000 for a married individual filing separately). Accordingly, any

indebtedness described in [*3] § 163 (h) (3) (C) (i) in excess of \$100,000 is, by definition, not home equity indebtedness for purposes of § 163 (h) (3).

In *Pau v. Commissioner, T.C. Memo. 1997-43*, the Tax Court limited the taxpayers' deduction for qualified residence interest to the interest paid on \$1 million of the \$1.33 million indebtedness incurred to purchase their residence. The court stated that § 163 (h) restricts home mortgage interest deductions to interest paid on \$1 million of acquisition indebtedness and \$100,000 of home equity indebtedness. Citing § 163 (h) (3) (B), the court stated that acquisition indebtedness is defined as indebtedness that is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and is secured by the residence. Citing § 163 (h) (3) (C), the court further stated that home equity indebtedness is defined as any indebtedness (other than acquisition indebtedness) secured by a qualified residence. The court concluded that the taxpayers failed to demonstrate that any of their debt was not incurred in acquiring, constructing, or substantially improving their residence and thus was not acquisition indebtedness. However, the court did not [*4] address the effect of the \$1 million limitation in § 163 (h) (3) (B) (ii) on the definition of acquisition indebtedness for purposes of § 163 (h) (3). The Tax Court followed *Pau in Catalano v. Commissioner, T.C. Memo. 2000-82*.

ANALYSIS

Taxpayer may deduct, as interest on acquisition indebtedness under § 163 (h) (3) (B), interest paid in 2009 on \$1,000,000 of the \$1,200,000 indebtedness used to acquire the principal residence. The \$1,200,000 indebtedness was incurred in acquiring a qualified residence of Taxpayer and was secured by the residence. Thus, indebtedness of \$1,000,000 is treated as acquisition indebtedness under § 163 (h) (3) (B).

Taxpayer also may deduct, as interest on home equity indebtedness under § 163 (h) (3) (C), interest paid in 2009 on \$100,000 of the remaining indebtedness of \$200,000. The \$200,000 is secured by the qualified residence, is not acquisition indebtedness under § 163 (h) (3) (B), and does not exceed the fair market value of the residence reduced by the acquisition indebtedness secured by the residence. Thus, \$100,000 of the \$200,000 is treated as home equity indebtedness under § 163 (h) (3) (C).

Under § 163 (h) (3) (A), the interest on both acquisition [*5] indebtedness and home equity indebtedness is qualified residence interest. Therefore, for 2009 Taxpayer may deduct interest paid on indebtedness of \$1,100,000 as qualified residence interest. Any interest Taxpayer paid on the remaining indebtedness of \$100,000 is nondeductible personal interest under § 163 (h).

The Internal Revenue Service will not follow the decisions in *Pau v. Commissioner* and *Catalano v. Commissioner*. The holding in *Pau* was based on the incorrect assertion that taxpayers must demonstrate that debt treated as home equity indebtedness "was not incurred in acquiring, constructing or substantially improving their residence." The definition of home equity indebtedness in § 163 (h) (3) (C) contains no such restrictions, and accordingly the Service will determine home equity indebtedness consistent with the provisions of this revenue ruling, notwithstanding the decisions in *Pau* and *Catalano*.

HOLDING

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 applicable dollar and fair market value limitations imposed on home equity indebtedness [*6] by § 163 (h) (3) (C)).

DRAFTING INFORMATION

The principal author of this revenue ruling is Sharon Hall of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Ms. Hall at (202) 622-4950 (not a toll-free call).