

Deductibility of Personal Interest and the Home Mortgage Exception

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Overview

The rules for the deductibility of interest can be a bit tricky. Also, to properly account for interest, the definition of interest is critical. In addition, there apparently is some confusion that has arisen concerning the proper classification of lender fees for tax purposes.

Today's article takes a look at the deductibility of one of the classifications of interest – personal interest. A subsequent article will take a look at the tax deductibility of investment interest and business interest.

The tax treatment of personal interest and the exception for mortgage interest - it's the topic of today's post.

Background

Presently, there exist different rules for the three types of interest: personal interest, investment interest and business interest. For farmers and ranchers, the bulk of farm interest should be deductible as business interest. That makes the classification of interest the end of the inquiry critical to determining the proper tax treatment.

Personal Interest and the Exception for Mortgage Interest.

Personal interest is *not* deductible unless the debt is secured by a mortgage on the principal residence, which is referred to as qualified residence interest. I.R.C. §§163(h)(2)(D); (h)(3). Generally, qualified residence interest is any interest paid on a loan secured by the taxpayer's main home *and* one other residence. See, e.g., *Boehme v. Comr.*, T.C. Memo. 2003-81 (where loan was acquisition debt, but repayment was secured by taxpayer's right to receive future lottery payments rather than the residence, loan interest was not qualified residence interest). If the other residence is rented out, the taxpayer or a member of the taxpayer's family must use the second home for more than the greater of two weeks or 10 percent of the number of days when the residence is rented for a fair rent to persons other than family members. The loan may be a mortgage to buy the home, or a second mortgage. The exception to the rule of nondeductibility of personal interest applies to "qualified residence interest." That is defined as interest associated with the taxpayer's principal residence on the first \$750,000 (\$375,000 if married filing separately) of indebtedness. These limits apply to the combined amount of loans used to buy, build or substantially improve the taxpayer's main home and second home. The deduction is on a per taxpayer basis to unmarried co-owners of a qualified residence. See, e.g., *Voss v. Comr.*, 796 F.3d 1051 (9th Cir. 2015).



Note: A higher limitation applies (\$1 million (\$500,000 if married filing separately)) if the mortgage interest is attributable to indebtedness incurred before December 16, 2017. Through 2022 this threshold also included mortgages taken out before October 13, 1987.

If the residence contains a business office for which a home office deduction is claimed, an allocation must be made between the part of the home that is the qualified home and the part that is not. The business portion of the home mortgage interest allowed as a deduction is included in the business use of the home deduction that is reported on Schedule C (Form 1040), line 30, or Schedule F (Form 1040), line 32. For taxpayers that itemize deductions on Schedule A, the personal part of the deductible mortgage interest is reported on Schedule A, line 8a or 8b and the business portion is reported on Schedule C (or F).

Mortgage interest is not deductible unless the taxpayer files either Form 1040 or 1040-SR and itemizes deductions on Schedule A. Also, the mortgage must be secured debt on a qualified home in which the taxpayer's has an ownership interest. The mortgage must provide that the home satisfies the debt in the event of default. The mortgage must be recorded, and both the taxpayer and the lender must intend that the loan be repaid. A "wraparound mortgage" is secondary financing and is not secured debt unless it is recorded or otherwise perfected under state law.

Note. For tax years 2018 through 2025, an interest deduction is no longer available for home equity indebtedness unless the indebtedness is used to buy, build or substantially improve the taxpayer's personal residence that secures the loan. The total loan balance (first mortgage and home equity loan is subject to the \$750,000 (mfj) limitation. *IR 2018-32, Feb. 21, 2018.*

An election can be made to treat secured mortgage debt as not secured by the home. The election may only be revoked with IRS consent. The election might make sense in situations where the debt would be fully deductible as business debt regardless of whether it qualifies as home mortgage interest and would allow a greater interest deduction on another debt that would give rise to a deduction for home mortgage interest.

Unique Situations

Divorce. Questions concerning the deductibility of qualified residence interest can arise in unique situations. For example, if a divorce decree or separation agreement requires the taxpayer to make all of the mortgage payments on a jointly owned home with an ex-spouse, the taxpayer and the ex-spouse may each treat one-half of the interest payments as qualified residence interest if the home is a qualified residence. *IRS Pub. No. 504 (2022), p. 14.*

Retirement plan. If a loan from a qualified retirement plan is characterized as a distribution and is a bona fide loan, the interest may satisfy the definition of qualified residence interest. *F.S.A. 200047022 (Aug. 22, 2000).*

Trust or estate. Simply transferring title of a qualified residence to a trust does not disqualify the grantor's continued payment of interest on the indebtedness as deductible qualified residence interest. *See, e.g., Investment Research Associates Limited & Subsidiaries v. Comr., T.C. Memo. 1999-407.* After the grantor dies, if the estate or a trust pays interest on a mortgage attributable to a



residence that the estate or trust holds, the interest is treated as qualified residence interest if the residence is a qualified residence of a beneficiary having a present or residuary interest in the estate or trust. *I.R.C. §163(h)(4)(D)*.

Mortgage interest refunds. The IRS ruled in *Rev. Rul. 92-91, 1992-2 CB 49*, that an interest overcharge due to the lender's miscalculation of an adjustable-rate mortgage that the cash basis borrower paid was deductible in the year paid as qualified residence interest even though it was reimbursed in a later tax year.

Conclusion

A subsequent article will take a look at investment interest and business interest. Included in the discussion will be the issue of whether loan extension fees meet the definition of deductible business interest. That's an issue that arisen recently with respect to some farm loans.

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