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Interest Deduction for Individuals: Review and Update

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INTEREST DEDUCTION FOR INDIVIDUALS: REVIEW AND UPDATE

by

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Individuals are permitted to deduct certain listed itemized deductions in computing their taxable income. One of the most important is interest expense.[1] Although neither the Code or the Regulations define the term "interest," it is generally considered to be the amount paid for the use or forbearance of money. It does not include payments to the lender for services rendered. These expenditures are capitalized and, where applicable, amortized over the life of the loan.[2]

The Tax Reform Act of 1986 severely limited this deduction by enacting I.R.C. § 163(h) which disallowed the deduction for all personal interest. This term includes all interest paid by an individual except if it is:

1) interest from a trade or business;
2) investment interest;
3) interest deducted in calculating a passive activity's income or loss;
4) qualified residence interest, or
5) interest on installment payments of the unified transfer tax under sections 6163 or 6166.

The amount of qualified residence interest is further limited by I.R.C. § 56(b) for taxpayers subject to the alternative minimum tax.

This article will review the current cases and rulings involving business, investment and qualified residence interest. It will point out areas of uncertainty as well as planning opportunities and pitfalls.

A. Interest Expense

As previously mentioned, section 163(h) limits the deduction for interest expense by individuals. Before this limitation and its exceptions can be applied, the taxpayer must determine the type of interest expense that was incurred. Reg. § 1.163-8T provides the rules for allocating interest expenses for purposes of the limitations.

Reg. § 1.163-8T(a)(3) states that, in general, interest expense is allocated in the same manner as the associated debt. The debt is allocated by tracing the debt to the specific expenditures funded by the debt. The allocation is made when the loan proceeds are first expended. The allocation remains until the debt is repaid or reallocated. Reallocation will occur on the sale of an asset acquired by the debt. The reallocation traces the use of the proceeds from the

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1. I.R.C. § 143 (1988).

2. *See* Goodwin v. Commissioner, 75 TC 424 (1980) *aff'd*, 691 F.2d 490 (3d. Cir. 1982).

sale. Reallocation will also occur on the change in character of the first expenditure. For example, reallocation is necessary where the activity involved is no longer a passive activity.[3]

There is one major exception to the general allocation rule. Qualified residence interest is calculated and allowed as a deduction without regard to the allocation of the debt proceeds.[4]

In addition to determining the allocation of the interest, the taxpayer must be able to prove that she actually paid the interest. Since most individuals are on the cash method, this usually requires an actual cash expenditure. Interest withheld by the lender (i.e. a discounted loan) is not considered paid until the loan is repaid.[5] If the taxpayer incurs a second debt to repay an existing debt, the interest on the first debt may or may not be considered paid.[6] If the second loan is from a different creditor, the first loan and interest are considered paid. When both loans are from the same creditor, the taxpayer has to prove that she had exercised unrestricted control over the funds to be treated as having repaid the first loan. Otherwise, the taxpayer will be denied the deduction for interest and any allowable fees on the basis of failure to have actually paid the expense.

B. Business Interest

As previously stated, § 163(h) contains an exception to the disallowance of personal interest expense deductions for interest allocable to a trade or business. The Code excludes from the definition of trade or business for purposes of this section the performance of services as an employee. It is not surprising, therefore, that the I.R.S has ruled that interest on student loans is personal, non-deductible interest.[7] Although the ruling does not address the issue, the denial of the deduction should also apply to student loans incurred to pay for deductible employee education expenditures. Although it is possible for a taxpayer in this situation to argue that under the "origin of the claim" doctrine the deduction should be considered as part of her education and therefore allowable as part of an education expense deduction, it is more likely that the specific Code provision denying interest associated with employment will prohibit the deduction.

Without mentioning it specifically, the I.R.S. used the "origin of the claim" doctrine in this manner against a taxpayer in a recent Tax Court case.[8]

3. Temp. Reg. § 1.163-8T(j).

4. Temp. Reg. § 1.163-8T(m)(3).

5. Rubnitz v. Commissioner, 67 TC 621 (1977).

6. For a more complete discussion of this issue with citations, see Rutland v. Commissioner, 79 TC 751 (1982).

7. Priv. Ltr. Rul. 88 -22- 020 (March 1, 1988).

8. McKay v. Commissioner, 102 TC 465 (1994).

The case dealt with a lawsuit in which the taxpayer sued his former employer for wrongful discharge, breach of his employment contract, RICO violations, and punitive damages. In order to pay his legal expenses, he was forced to borrow money. He deducted the interest as business interest. The Tax Court agreed with the I.R.S. that the lawsuit arose out of his business of being an employee. As such, the court held that the expense was personal interest. In other words, the "origin of the claim" was the taxpayer's employment. Therefore, the suit relates to employment and is covered by the Code prohibition against deduction of personal interest. All interest associated with employment is likely to be non-deductible.

The denial of interest expense related to employment could cause difficulty in an entirely different line of cases. For years, taxpayers who purchased stock in, or loaned money to, a corporation to protect their employment have argued that losses and bad debts associated with the stock purchases and loans were business losses and therefore fully deductible.[9] To the extent taxpayers are successful with this argument, any interest paid to borrow the money used to buy the stock or to make the loan would be non-deductible interest because it relates to employment.

Recently, the I.R.S. addressed this issue in Rev. Rul. 93-68.[10] According to this ruling, the interest from a loan to purchase stock is investment interest, and its deductibility is limited accordingly. The ruling states that this conclusion applies regardless of the taxpayer's motive in purchasing the stock.

Although the ruling limits deductibility of the interest, it may be viewed as favorable to the taxpayer employee. If the Service had concluded that motive was relevant, then anytime there is a dominant business motive, the interest would be completely non-deductible. Since the business motive would be protection of employment, the prohibition against employee interest would apply. Rev. Rul. 93-68 eliminates the possibility that the Service will attempt to deny a deduction for interest for stock purchases when the shareholder is also an employee of the corporation.

1. Interest on Tax Deficiencies

The Code allows individuals to deduct business interest unless it is related to employment. Reg. § 1.163-9T excludes from the definition of business interest that which arises on tax deficiencies and on loans to pay tax deficiencies regardless of the source of the income generating the tax. An example in the regulations illustrates this exclusion for a tax deficiency resulting from an understatement of S corporation income. The example states that

9. *See, e.g.* Miller v. Commissioner, 70 TC 448 (1978) (argueing for business rather than investment interest).

10. 1993-2 CB 72.

the same result would occur if the income was from a sole proprietorship.

Interest paid on certain taxes is exempt from this exclusion.[11] These taxes include sales and excise taxes incurred in a business, taxes paid by an S corporation relating to a prior C corporation year, and taxes paid by a transferee under I.R.C. § 6901. These regulations have resulted in several court cases.

In *Miller v. United States*,[12] a District Court considered whether an individual could deduct the interest on a tax deficiency arising out of a sole proprietorship. The court first considered the validity of the applicable regulations. It opened its analysis with the observation that, prior to 1986, the courts had uniformly held the interest expense in dispute was deductible for Adjusted Gross Income under I.R.C. § 62(a)(1). The court noted that the language in § 163(h)(2)(A) is similar to the language in I.R.C. § 162 and 62. Since these latter sections weren't changed by the Tax Reform Act of 1986, the implication exists that the prior cases are still applicable. This conclusion is consistent with the legislative history. The Conference Report states, "personal interest also generally includes interest on tax deficiencies."[13] According to the court, the committee would not have included the word "generally" unless there were occasions when the interest was not personal interest. The court pointed out that the first occasion that this interest was stated to be personal at all times was in the Report of the Staff of the Joint Committee on Taxation. Since this bluebook is a post enactment explanation, it is not on par with the legislative history. Finally, the court cited an article by two law experts that also concluded that the bluebook goes beyond the language of the Code. The court, therefore, concluded that Reg. § 1.163-9T(b)(2)(A) was overly broad and invalid.

The *Milller* court then addressed the issue as to whether the interest expense met the test for deductibility under § 162. According to the court, the fact that the regulation was held invalid does *not* make all interest associated with a sole proprietorship deductible. Rather, its deduction is permitted provided the taxpayer can prove that it was an ordinary and necessary expense as defined in § 162.

The *Miller* court considered *Commissioner v. Polk*[14], the seminal case on the deductibility of interest. In that case, the deficiency was the result of a valuation dispute in the taxpayer's business of raising and producing livestock. Based on its review of *Polk* and other cases cited by the taxpayer, the *Miller* court concluded:

11. Temp. Reg. § 1.163-9 T(b)(2)(iii).
12. 841 F. Supp. 305, (D.N.D. 1993).
13. *Id.* at 309.
14. 276 F.2d 601 (10th Cir. 1960).

> Unless the taxpayer's error which caused the underlying income tax deficiency is ordinarily and necessarily to be expected in the taxpayer's type of business, interest on a deficiency assignment of additional tax is not properly considered ordinary or necessary to the operation of taxpayer's business, and therefore may not be deducted.[15]

Applying the standard from *Polk,* the *Miller* court concluded that the expense was not ordinary or necessary, since it was the result of an improper deferral scheme. There was no real issue in dispute. Professionals would not disagree over the proper treatment of the disputed income in *Miller.* Therefore the interest expense was not ordinary and necessary. The final result was that the interest was personal and nondeductible.

Although the taxpayer lost in *Miller,* the decision leaves open the possibility of a deduction. However, the case places the burden of proof with the taxpayer to prove that there was a sufficient disagreement as to the proper tax treatment to raise the expense to the level of ordinary and necessary. It may be impossible for the taxpayer to meet this burden: in *True v. United States,*[16] the Tenth Circuit Court of Appeals, the same circuit that decided *Polk,* stated in a footnote:

> We believe, as did the panel presiding in Polk, that Polk settled a unique controversy. The parties have not presented any facts nor can we imagine another situation in which the penalty interest would be an ordinary and necessary expense of operating a trade or business.[17]

Given the complexity of modern business and of the Internal Revenue Code itself, the footnoted statement of the Tenth Circuit seems unreasonable if the standard is whether there exists an honest disagreement by qualified professionals. There is simply too much litigation and too much discussion of the need to simplify the law to assume that real differences of opinion do not exist. However, if the courts apply the aforementioned statement, or draw a similar conclusion, to future cases, all tax deficiency interest will, in fact, be held to be personal and non-deductible, thereby upholding the conclusion of the questioned regulation despite its invalidity.

The issue of deficiency interest was recently litigated in *Redlark.*[18] Taxpayer paid and deducted interest from a deficiency arising from accounting errors in the application of the cash and accrual methods. The Tax Court concluded that the temporary regulation was invalid and that the interest met the definition of an ordinary and necessary expense based on *Polk.* The court interpreted the quoted statement from *Miller* as simply reemphasizing the

15. Miller v. United States, 1994 WL 714069 at *2.

16. 35 F.3d 574 (10th Cir. 1994).

17. *Id.*

18. Redlark v. Commissioner, 106 TC 2, (1996).

requirement that the interest be a business deduction and not a per se denial of all deficiency interest deductions.

The question of the deductibility of deficiency interest in a partnership context was raised in *True*.[19] The taxpayer deducted the interest on a deficiency arising out of adjustments to income reported as partners and S corporation shareholders. The Service denied the deduction and the District Court ruled for the Service.[20] In reviewing the background of the case, the District Court stated:

> The IRS contends that although an interest payment on tax deficiencies is generally viewed as an above the line business expense for sole proprietorships and C corporations, such payments are not business expenses for partnerships and S corporations, because these latter forms of business organization have no duty to pay income tax.[21]

The denial of the deduction for partners and S corporation shareholders follows directly from Reg. § 1.163-9T. The statement that the IRS contends that interest on deficiencies of sole proprietorships are business expenses conflicts with the position taken by the Treasury in the previously discussed cases. Perhaps the Service is litigating this issue as to sole proprietors solely because the temporary regulations prohibit the deduction, however they recognize that the majority of precedent would allow the deduction, provided the deficiency is the result of an honest disagreement as to the tax treatment of the contested item.

The court states that the issue raised in *True* is really whether to apply the "entity" or the "aggregate" approach to partnership taxation. The court concludes that the entity approach is the correct approach. As support for the conclusion that the interest is personal under the entity approach, the court cites *United States v. Basye*.[22] The partnership is a separate entity from its partners, and, therefore, the partnership alone would be entitled to the deduction since it is the business' expense. It is not an expense of the partners. On the other hand, since a partnership does not pay tax, it cannot incur any expenses related to the tax. The court recognizes that their conclusion results in no deduction, either at the entity or partner level, for the expense. Since the taxpayer selected the form of business, she must bear the consequences of her choice — in this case, the loss of a deduction. The court's conclusion as it relates to partnerships is open to question.

The issue addressed by the Supreme Court in *Basye* is whether income

19. True v. United States, No. 91-CV-1004-J, 1993 WL 379417 (D. Wyo. 1993), *aff'd*, 35 F. 3d 574 (10th Cir. 1994).

20. *Id.*

21. *Id.* at *1.

22. 410 US 441, (1973).

earned by a partnership should be included in partnership income even though it was paid directly to the partners. The Court concluded that under the entity approach the partnership must report the income.

The Court cited I.R.C. § 703 for the requirement that a partnership must compute its taxable income similarly to an individual. The Court then states:

> For this purpose [computing income], then, the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.[23]

In other words, a partnership is an entity solely for purposes of computing its income. For all other purposes, it is an aggregate of its partners. Given this interpretation of *Basye*, it is possible to argue that a partner is in fact engaged in a trade or business to the extent she reports income. Thus, interest paid on a deficiency resulting from this reported business income should be deductible provided it meets the ordinary and necessary test of § 162.

A partner can also argue that she should be treated as engaged in the business of the partnership based on I.R.C. § 1402. This section requires each partner to report and pay self-employment tax on her share of partnership income whether or not distributed. Under Reg. § 1.1402(a)(1)(b), the amount of net earnings from self employment for a partner includes any payment ". . . for the use of capital by the partnership." The inclusion of guaranteed payments for capital equates a partner with a sole proprietor. The total income of the business, that based on both services and capital, is subject to self employment tax. If a partnership were a separate entity from the partners, the income from the use of capital should not be self-employment income, but portfolio income similar to interest earned on loans. Since the regulations treat the total income as earned, it follows that the partner is being treated as engaged in the business of the partnership. Under this approach, the regulations employ the aggregate theory.

This argument applies to partnerships, but not to S corporations. Section 1402 does not include the undistributed income of an S corporation in self-employment income. In fact, I.R.C. § 1371 applies the corporate rules of Subchapter C, not the partnership rules of Subchapter K, to S corporations. In other words, an S corporation is an entity separate from its shareholders, except in the case of the waiver of the corporate level tax.

Although it can be argued that partners should be entitled to deficiency interest deductions, the deduction is denied by both the Regulations and case law. A taxpayer claiming this deduction should be prepared to argue its merits

23. *Id.* at 447.

in litigation.

Reg. § 1.163-9T(b)(2)(i)(C) states that personal interest includes any interest paid by a trust, an S corporation, or any other pass-through entity on the underpayment of taxes or loans to pay taxes. Therefore, these amounts would be non-deductible.

The Service has privately ruled that this regulation also applies to estates.[24] The taxpayer in the ruling request stated that the estate borrowed money to pay taxes and administrative costs to prevent the sale of assets at depressed prices. The estate requested a ruling allowing the deduction for estate income tax purposes, provided it filed the requisite statement giving up the estate tax deduction. The Service ruled that the estate could not claim an income tax deduction for the interest. Even though the loan was necessary to avoid a "fire sale" of estate assets, the loan was still to pay taxes, and therefore the interest is non-deductible personal interest. However, the ruling goes on to state that to the extent the estate can prove that loan was reasonable and necessary to the administration of the estate, the interest can be deducted on the estate tax return as an administration expense pursuant to Rev. Rul. 84-75.[25]

This ruling confirms the Service's position that interest to pay taxes is non-deductible personal interest. The Service has ruled privately that there is an exception to this rule for interest by a transferee for underpayments of taxes relating to a C corporation. In this ruling, a corporation liquidated and distributed its assets to a trust in December, 1990. The trust requested that the Service examine the tax returns for 1988, 1989 and 1990. In 1991, the agent and the trustee reached an agreement that the trust owed $131,992 in taxes, $50,108 in interest and $881 in penalties. The taxpayer requested rulings on the treatment of the different items assessed.

The ruling held that the $131,992 in taxes and $881 in penalty fees are long-term capital losses. This conclusion is based on *Arrowsmith v. Commissioner,*[26] Rev. Rul. 72-137,[27] and *Johnson.*[28] Since these two items are contingent liabilities of the corporation, they are really adjustments to the prior capital gain reported on the corporate liquidation under I.R.C. § 331. Although this conclusion appears to equate the shareholder who paid these amounts with a shareholder of another corporation that received fewer assets because the corporation paid its liability before liquidation, the taxpayer is not made completely whole. The shareholder had to pre-pay the tax on the excess reported capital gain. In addition, the capital loss might not be completely

24. Priv. Ltr. Rul. 94-49-011 (Sept. 9, 1994).

25. 1984-1 CB 193.

26. 344 U.S. 6 (1952).

27. 1972-1 CB 101.

28. Johnson v. Commissioner, 19 TC 465, Acq. 1953-2 CB 5.

deductible in the year of payment. Due to the $3,000 limit on deductibility of capital losses, some of the loss may not be deductible until future years. Based on time value of money principles, the taxpayer will be worse off than if the corporation had paid the liability. On the other hand, the capital loss can offset up to $3,000 of ordinary income. To the extent that the capital gain tax rate is less than the ordinary income tax rate, the shareholder receives a benefit from the payment of the liability. In most cases, the prepayment of taxes will be a greater detriment than the benefit gained from the rate differential.

The ruling also discussed the timing and classification of the $50,108 of interest paid. The timing of the deduction is the easier question. In Rev. Rul. 70-560,[29] the Service ruled that an accrual basis taxpayer should deduct interest on a tax deficiency in the year that the deficiency is determined or agreed. The Service applied this ruling to the trust to conclude that the interest was accrued in 1991, the year of the agreement. It would appear that if the taxpayer was a cash basis taxpayer, the amounts would be deductible in the year paid.

The classification of the interest was more difficult. Based on the temporary regulation and on *Johnson*[30] decision, the Ruling concluded that the interest is not non-deductible personal interest. However, the ruling notes that part of the interest had accrued before the liquidation, and part had accrued after the liquidation. The part that accrued before the liquidation is really a contingent liability of the corporation and, as in the case of the other contingent liabilities, will generate a long-term capital loss on payment. The part that accrues after liquidation is interest and would be deductible under the exception in the temporary regulation. The Ruling treats all the corporate liabilities consistently and logically. The end result, however, is to restrict the deduction of transferee interest and the usefulness of the exception. The classification of that part of the interest that accrued before liquidation as a capital loss, although not as beneficial as the taxpayer had requested, is still more beneficial than if it had been classified as non-deductible personal interest.

2. Pass-Through Entities

The entity/aggregate dichotomy associated with partnerships and S corporations results in additional complications when determining the deductibility of interest incurred by the entity or related to the purchase of the entity. To resolve some of these questions, the Service has issued some guidance. Although most of the published guidance involves partnerships and S corporations, the rules also apply to a trust in which a taxpayer is treated as the owner under the grantor trust rules.[31]

29. 1970-2 CB 37.

30. *Johnson*, 19 TC at 468.

31. *See, e.g.* Priv. Ltr. Rul. 90-31-022 (May 7, 1990).

One question addressed by the Service is the characterization of interest expense incurred by a pass-through entity that is allocable to an owner. This is covered by Reg. § 1.163-8T. Under this regulation, the interest expense follows the debt and the debt is allocated by tracing the disbursements of the debt proceeds. Detailed rules are provided for situations in which the tracing of the proceeds is unclear. In general, if the debt proceeds are used in the business, the interest is business interest that is fully deductible by the owner. If the owner does not materially participate in the business, the interest is part of the passive income/loss computation. If the proceeds were issued to purchase investment assets, the interest is investment interest limited by § 163(d).

The division of assets owned by a pass-through entity into business and investment assets is relatively straightforward. However, there is one unexpected result. Section 163(d)(5)(A) states that investment property includes property described in I.R.C. § 469(e)(1). This section provides that investment (portfolio) income is not earned in a trade or business and therefore is not part of a passive loss. It specifically includes in portfolio income interest earned on invested working capital. Since working capital generates portfolio income, it is an asset not used in a trade or business. As a result, interest expense to provide working capital for a pass-through entity will be classified as investment interest and not business interest. This part of the pass-through interest expense will be limited by § 163(d).[32] From a planning perspective, it would be better to use contributed capital for working capital and borrowed funds to purchase business assets.

The regulations describe the allocation methodology for interest expense incurred by a pass-through entity. They do not discuss the interest on a loan to purchase an interest in a pass-through entity. However, the Service addressed this issue in Notice 89-35. It provides that the interest incurred to purchase an interest in an entity will be allocated based on the assets within the entity. This allocation can be done using any reasonable method. The Notice provides that the normal allocation methods include pro-rata allocations based on fair market value or book value, each reduced by entity debt allocated to the assets. To be a reasonable method, it must be used consistently each year.

The allocation of interest on a loan to make a capital contribution to the entity or purchase an interest in the entity where the entity receives the proceeds can be different from the previous allocation. In addition to the pro-rata allocation previously discussed, taxpayers can use actual tracing of the proceeds as if the contribution was a loan made to the entity. Again, the method should be applied consistently from year to year.

32. *See* Priv. Ltr. Rul. 92-15-013 (Jan. 7, 1992).

The method of allocation selected will result in different amounts of deductible interest. The method that provides the largest deduction will vary depending on the relationship of value to basis. No one method will always be superior. A taxpayer should compare the various alternatives before selecting the method to be used.

Two additional questions can arise involving business interest. The first involves the assumption of debt. If the owner of a business assumes a debt of that business, what is the proposed characterization of the interest expense? Does the reason for the assumption change the result? The Service addressed these questions in a Private Letter Ruling concerning the assumption of an S corporation's debt by its shareholders.[33] The Service analyzed the questions using the interest allocation regulations. Under Reg. § 1.163-8T, interest is allocated at the time the expenditure is made. It is reallocated on the occurrence of specific events. This reallocation occurs on the earlier of (1) the reinvestment of the proceeds of the sale of the assets acquired with the loan proceeds, or (2) the change in the character of the first expenditure. The assumption of the debt is not covered by the reallocation rules. Therefore, the assumption does not change the allocation. If the interest expense to the S corporation would have been business interest then it would remain business interest following the assumption. If it was investment interest it remains investment interest. The assumption has no effect on the characterization. Therefore, if it were included in taxpayer's passive loss before the assumption, it will be included in the passive loss after the assumption. The fact that the assumption does not change the classification of the interest does not mean that the assumption has no other tax consequences. For example, the assumption might change the taxpayer's basis in the entity. This will change the limit on the deduction of an allocated loss and might affect the taxation of a distribution. These results are separate from the characterization of the interest expense issue.

Another question is the proper classification of a guaranteed payment to a partner for use of capital. According to I.R.C. § 707(c), a guaranteed payment is one that is calculated without regard to the partnership income. These amounts are considered paid to a non-partner, but only for purposes of § 61 and §162.[34] Since a guaranteed payment for use of capital is in the nature of interest, the issue arises as to whether this expenditure is interest expense and therefore subject to the limits of § 163. It is the Treasury's position that these payments are not interest expense, and are, therefore, not subject to § 163.[35] This conclusion is based in part on the fact that § 707(c) refers to § 162 and not § 163. More importantly, § 707(c) creates a fictional debt, not a real liability, and that this fiction is solely for purposes of § 162. In other words, the

33. Sept. 14, 1989.

34. Deductibility is subject to the capitalization rules of § 263.

fiction is used to impose an ordinary and necessary standard on the deductibility of the payment rather than to reclassify the payment as interest.

This conclusion is interesting because the very same guaranteed payments which are deductible without regard to § 163 are, in the Treasury's opinion, interest income to the recipient.[36] This conclusion is based on the legislative history of § 707(c), and the fact that § 61(a)(4) lists interest. Since § 707(c) refers to § 61(a), it would apply to all the paragraphs within this subsection.

The Treasury does not address the question of the type of interest income. Specifically, is it investment income which will increase the amount of investment interest expense deductible under § 163(d)? Since the Treasury's position is to divorce the tax treatment of the recipient from that of the payor, the classification should be based solely on the recipient. At this level, it is interest received for an investment in an entity. This view would place the interest well within the definition of investment income.

Assuming these conclusions are upheld, there appears to be a small but useful planning opportunity available to partnerships. They should consider paying guaranteed payments for use of capital. This will generate investment income for the partner, which might increase her interest expense deduction without creating interest expense limited by § 163. However, this opportunity is limited. To the extent that the partners make excess contributions over what is needed by the entity, the new anti-abuse regulations under I.R.C. § 701 can be used to deny the taxpayer her intended benefit.

C. Investment Interest

Investment interest is exempted from the denial of the deduction of personal interest. The amount of investment interest that is deductible in any year is limited by § 163(d).

Pursuant to § 163(d), the amount of investment interest deductible each year is limited to the amount of net investment income reported in that year.[37] Investment interest expense in excess of the amount deductible is carried forward and treated as paid in the succeeding year. This results in an unlimited carryforward of excess investment interest.

1. Investment Interest Expense

Investment interest expense is defined as interest paid on a debt allocated to property held for investment.[38] Specifically excluded from this definition is interest qualifying as residence interest and interest included in computing

35. GCM 36702 (Apr. 12, 1976) and GCM 38133 (Oct. 10, 1979).

36. *Id.*

37. Sec. 163(d)(1).

38. Sec. 163 (d)(3)(A).

passive income or loss.[39]

Property held for investment is property that generates portfolio income such as interest and dividends. Thus, stocks and bonds are investment property. It is immaterial if the stock was purchased to protect taxpayer's employment[40] or to become a member of a cooperative.[41] The pre-1986 cases which examined the taxpayer's motive are no longer applicable since the law was changed to include a specific definition of investment property which does not mention intent.[42]

Generally, an investment in real estate will produce either business or passive income. Therefore, any related interest is excluded from the definition of investment interest. However, if the real estate activity is insufficient to qualify as a business, then the real estate is an investment activity and all related interest is investment interest. Again, it is immaterial if the real estate was purchased with the intent to form a business. The activities must actually constitute a business to avoid investment classification.[43]

2. Net Investment Income

Net investment income is the excess of investment income over related investment expenses.[44] Investment income is the sum of:

1. gross income from properties held for investment;
2. the excess of the gains from disposition of investment property over the net capital gain from such dispositions; and
3. the amount of the net capital gain from disposition of investment property elected by the taxpayer.

Property held for investment includes property which produces income described in § 469(e)(1) and any interest in an activity involving a trade or business which is not a passive activity and in which the taxpayer does not materially participate.[45] Section 469(e)(1) describes portfolio income, which includes interest, dividends, annuities, royalties not derived in the ordinary course of business and gains from the disposition of property producing these items of income. These definitions do not mention intent. Similarly, there is no mention of property producing investment interest expense. As a result, there is no symmetry between investment interest income and investment interest expense as well as the inclusion in investment income of unexpected items. For example, the Service has ruled that interest on a tax refund is in-

39. Sec. 163(d)(3)(B).
40. Rev. Rul 93-68, 1993-2 CB 72.
41. Priv. Ltr. Rul. 92-09-004 (Oct. 31, 1991).
42. *Id.*
43. Christian v. Commissioner, TC Memo 1995-12 (U.S. Tax Ct. 1995).
44. Sec. 163(d)(4).
45. Sec. 163(d)(5).

vestment income even though interest on a tax deficiency is personal interest and tax refunds are not normally considered investment property.[46] It is important to keep this expansive definition in mind when calculating investment income.

The Tax Reform Act of 1993 changed the definition of investment income. For any year after 1992, investment income includes only that part of a taxpayer's net long-term capital gain from the disposition of investment property that she elects.[47] Any amount included in investment income is excluded from the provision limiting the tax rate applied to capital gains.[48] Since the inclusion of a capital gain in investment income is voluntary, the taxpayer must decide if the current deduction of the extra interest offsets the loss of the reduced capital gain tax rate. For a taxpayer in the 39.6% bracket who could use the investment interest expense carryover the following year, the election would be profitable if she could earn over 40% after-tax on the tax savings in the current year. The longer the deferral in the use of the carryover, the lower is the required rate of return. However, unless the carryover will be deferred for a very long-time, the taxpayer will probably be better off not electing to include any capital gains in investment income based on the high required rate of return to break-even from the election.

For years before 1987, taxpayers and the IRS disagreed as to the amount of the interest expense carryover. For those years, § 163(d)(2) limited the carryovers to the amount disallowed *solely* by § 163. Therefore, if the deduction was limited because the taxpayer had insufficient taxable income, the Service's position was that no carryover was allowed. The issue was litigated several times and the IRS lost each time.[49] The I.R.S. eventually conceded defeat in a 1995 Revenue Ruling.[50] For all years, whether before or after 1986, taxpayers can carryover the excess of their investment interest expense over their investment income without regard to their taxable income. This should finally put this issue to rest.

D. Qualified Residence Interest

One of the most important exceptions to the disallowance of personal interest is the deductibility of qualified residence interest. A taxpayer may deduct the interest incurred on either acquisition debt or home equity debt.

"Acquisition debt" is a debt incurred to purchase, construct, or substantially improve a qualified residence. It also includes a debt that refinances qualified acquisition debt. The debt must be secured by the residence. In

46. Priv. Ltr. Rul. 93-07-005 (Oct. 27, 1992).
47. Sec. 163(d)(4)(B)(iii).
48. Sec. 1(h).
49. *See* Allbritton v. Commissioner, 37 F.3d 183 (5th Cir. 1994).
50. *See* Rev. Rul. 95-96, 1995-8 I.R.B. 4.

addition, the debt may not exceed $1,000,000 for any period. "Home equity debt" is any other debt secured by a qualified residence. It cannot exceed the lesser of the value of the residence reduced by the acquisition debt or $100,000.

1. Qualified Residence

A qualified residence means the principal residence of the taxpayer and one other residence selected by the taxpayer. The term principal residence has the same definition for this purpose as it does for purposes of I.R.C. § 1034, and a second residence has the same fourteen day minimum personal use requirement as contained in I.R.C. § 280A(d)(1).

2. Principal Residence

The Code does not define the term "principal residence." The regulations provide that the determination is based on all of the facts and circumstances.[51] Generally, the taxpayer must occupy and live in the residence.[52] It is possible for the taxpayer to move out of the residence while attempting to sell it without changing its classification.[53] In fact, the taxpayer can even rent the residence while attempting to sell it without changing it's classification.[54]

The Service has privately ruled on an important aspect of interest to this issue. In this Ruling, the taxpayers wished to acquire five acres of land contiguous to their residence. The residence was located on a fifteen acre plot. They planned to borrow money to purchase the additional land. The taxpayers requested a ruling as to whether this additional land, if it met all the additional tests, could qualify as part of the residence, making the interest on the debt deductible. The Ruling stated that the question of purchasing additional property was one of first impression. However, in *Bogley v. Commissioner*[55] the Court of Appeals for the Fourth Circuit allowed a taxpayer to obtain the benefits of § 112, the predecessor to § 1034, on the sale of land contiguous to the plot of land containing the taxpayer's principal residence following the sale of the residence. The court reasoned that the entire property was part of the taxpayer's residence, and as long as he didn't change the use of the retained acreage, it remained part of the residence. Based on this rationale, the letter ruling concluded that if the residence can be sold in two pieces, it can be bought in two pieces. Thus, provided that the land purchased after the residence is used as part of the residence, it will qualify as the taxpayer's principal residence and any associated debt is qualified acquisition debt.

51. Reg. Sec. 1.1034-1(c)(3).

52. *See* Perry, TC Memo 1994-247 (U.S. Tax Ct. 1994).

53. Claphan v. Commissioner, 63 TC 505 (1975).

54. *See* Bolares v. Commissioner, 776 F.2d 1428 (9th Cir. 1985) (considering five factors where property is rented).

55. 263 F.2d 746 (4th Cir. 1959).

Rev. Rul. 76-541[56] contains facts similar to the ones in *Bogley*. This ruling also permits § 1034 nonrecognition treatment for sale of land contiguous to, and used as part of, a residence which was previously sold.

Since the I.R.S. cited *Bogley* in the above private letter ruling as authority under § 163, even though it involves § 1034, taxpayers should be able to rely on it and Rev. Rul. 76-541, another § 1034 ruling, as authority under § 163 to address a slightly different question. Taxpayers who are having difficulty selling their residence because of the amount of acreage attached should be able to sell it in two parts without forfeiting the interest deduction under § 163. In these cases, it is important not to change the use of the retained land. It must remain for sale with the mortgage attached. If this is done, the interest paid on the debt securing the retained land should qualify as deductible residential interest.

3. Second Residence

Section 163 allows an individual to deduct the interest paid on indebtedness for a principal residence and a second residence. According to Reg. § 1.163-10 T(p)(3), property will qualify as a second residence if it meets three tests. They are:

1. The property is a residence as defined by regulation;
2. The property is used by the taxpayer as a residence; and
3. The property is elected by the taxpayer as the second residence.

Under the temporary regulations, "a residence generally includes a house, condominium, mobile home, boat, or house trailer that contains sleeping space and toilet and cooking facilities."[57] A residence does not include personal property.[58] In *Garrison*,[59] the Tax Court concluded that a vacant lot upon which taxpayer camped two weeks each year did not qualify as a second residence. Alternatively, the Tax Court allowed the taxpayer to claim as a second residence a building constructed on farm land that the taxpayer owned.[60] The structure met the definition of a residence and the other required tests even though it was located on a working farm.

The second requirement is that the taxpayer use the property as a residence. According to the regulations, the property must qualify under § 280A(d) if it is rented during the year.[61] If it is not rented at any time dur-

56. 1976-2 CB 241.

57. Temp. Reg. 1.163-10T(p)(3)(ii).

58. *Id.*

59. Garrison v. Commissioner, TC Memo 1994-200 (U.S. Tax Ct. 1994), *aff'd*, 67 F.3d 299 (6th Cir. 1995).

60. Lawler v. Commissioner, TC Memo 1995-26.

61. Temp. Reg. 1.163-10T(p)(3)(iii).

ing the year it is considered to be used as a residence by definition.[62] Section 280A(d) provides that a dwelling is used as a residence if the taxpayer uses the property for personal purposes for the greater of fourteen days or ten percent of the number of days rented during the year.

The third requirement is that the taxpayer elect to treat the property as a second residence. Neither the Code nor the regulations elaborate with respect to this requirement. Therefore, the Tax Court upheld the election although it was made at the time a petition was filed with the court in a suit disallowing the interest deduction.[63] Based on this decision, it appears that taxpayers can make the election at any time and in any reasonable manner.

4. Acquisition Indebtedness

As previously stated, the debt must qualify as either acquisition debt or home equity debt. To be acquisition debt, it must be debt incurred to either acquire, construct, or substantially improve a residence. Further, it must be secured by the residence.

To assist taxpayers in determining if the debt was used to acquire a residence, the I.R.S. issued Notice 88-74.[64] According to this Notice, debt will be assigned to home purchases based on the normal tracing rules of Reg. § 1.163-8T. As an alternative to the tracing rules, the taxpayer can treat any debt incurred within ninety days before or after the purchase of a residence as residential debt to the extent of the purchase price of the home. If the home is constructed or improved, this alternate rule is expanded to include expenditures for up to twenty-four months prior to the date the debt is incurred. The period after the completion of the residence remains at ninety days. The Notice also provides that any debt incurred to acquire the interest of a former spouse incident to a divorce will also qualify as residential debt.

If the taxpayer borrows funds to purchase a residence as well as other property, the part of the loan that is allocated to the residence can qualify as acquisition indebtedness.[65] The allocation is a factual question. Therefore, the taxpayer should put herself in a position to prove the reasonableness of the allocation. Use of a separately negotiated purchase price of the residence or an allocation based on relative fair market values may be reasonable depending on the circumstances.

Interest paid on debt treated as acquisition debt is deductible regardless of the source of the loan. Therefore, money borrowed from a pension plan can qualify as acquisition debt.[66] However, the interest deduction can be disal-

62. *Id.*

63. Lawler v. Commissioner, TC Memo 1995-26.

64. 1988-2 CB 385.

65. *See* Priv. Ltr. Rul. 89-49-086 (Sept. 14, 1989).

66. *See* Priv. Ltr. Rul. 89-33-018 (May 19, 1989) and Priv. Ltr. Rul. 89-35-051 (June 7, 1989).

lowed by other provisions of the Code that override § 163. Therefore, the interest deduction may be disallowed by I.R.C. § 72(p)(3) for loans made to key employees even if it meets all the requirements of § 163.

In addition to being incurred to acquire the residence, the Code requires that the debt be secured by the property. Since this requirement is contained in the Code, it will be strictly enforced.[67] For example, a debt allocated to the purchase of the home under Reg. § 1.163-8T will not be treated as acquisition indebtedness if the residence does not secure the debt.[68] On the other hand, if the requirements are otherwise met, the debt qualifies as residential debt regardless of other financial arrangements. For example, the fact that the creditor requires additional security in addition to the residence will not violate the security requirement.[69] The loan will still qualify as acquisition indebtedness.

In Rev. Rul. 92-91,[70] the I.R.S. considered another potentially problematic financial arrangement. The Ruling addresses the deductibility of interest on an adjustable rate mortgage when the creditor has accidentally overcharged the taxpayer. The Ruling holds that the interest is deductible when paid and is included in income under the 'tax benefit' rule when returned to the taxpayer. The return can be in cash or a reduction in the principal balance of the loan. The Ruling leaves unanswered the question of the character of the income reported — that is, whether it is investment income under § 163(d). Logically, it cannot be considered investment income, but an argument could be made that if interest on a tax refund is investment income because a true investment is not necessary, this amount should also be included in investment income. This argument is subject to a challenge on the ground that interest income from any source is different from the refund of an expense overpayment.

Acquisition indebtedness is debt incurred to acquire a residence and the debt is then secured by the property. Reg. § 1.163-10T(0)(5) permits a taxpayer to elect to treat qualified debt as non-acquisition debt. This election is effective for the tax year of the election and all subsequent tax years, unless the I.R.S. grants permission to revoke the election. In those cases in which the election is made, the interest ceases to be qualified residence interest. Depending on the use of the proceeds, the interest may become investment interest. For example, the I.R.S. has privately ruled on a situation where the proceeds of the debt were loaned to a partnership that owned rental property.[71]

67. Priv. Ltr. Rul. 89-06-031 (Nov. 10, 1988).

68. Priv. Ltr. Rul. 94-18-001 (Nov. 5, 1993).

69. Priv. Ltr. Rul. 89-49-086 (Sept. 14, 1989) and Priv. Ltr. Rul. 90-38-023 (Jan. 22, 1990).

70. 1992-2 CB 49 (illustrating the calculation of amount to be included in income).

71. Priv. Ltr. Rul. 93-35-043

In this Ruling, the Service concluded that the interest was investment interest. Another interesting question arises if the proceeds are invested in the residence itself. Can the taxpayer argue that although the property is her home, it was purchased with the anticipation of future capital gain and therefore the interest is investment interest? Under § 163(d), investment interest is interest accrued on property held for investment. Investment property is property not used in a trade or business and which generates portfolio income. It would appear that a residence could meet this definition of investment property.

Taxpayers should consider the election for the amount of debt that exceeds the maximum dollar amount contained in § 163. If the elected interest is reclassified as personal interest, the taxpayer is no worse off, and if it is reclassified as investment interest, she is better off. Even if the interest is not currently deductible because of insufficient investment income, the election would be beneficial to the taxpayer since excess investment interest expense can be carried forward and deducted in a subsequent year, whereas debt that exceeds the § 163 limit generates interest that is not deductible.

5. Alternative Minimum Tax

Section 163(h) defines the term qualifying residence as the taxpayer's principal residence and a second residence. As previously discussed, the second residence can include boats and housetrailers provided they have sleeping and cooking accommodations. An individual's interest expense deduction is also limited for purposes of the alternative minimum tax (AMT).

An individual's itemized deduction for interest for purposes of the alternative minimum tax is limited to qualified housing interest.[72] This term is defined to include the taxpayer's principal residence and one other qualified dwelling used as a residence.[73] A qualified dwelling is defined as a house, apartment, condominium or mobile home not used on a transient basis.[74] Thus, the second residence for AMT purposes is more limited than the one for regular tax purposes. It does not include boats and housetrailers. There are no regulations or other precedents that elaborate on the list of items that are either included or excluded from this definition. It would appear that the AMT attempts to limit the deduction to buildings that are permanently attached to land. For those taxpayers that own a second home and a yacht or other mobile facility with sleeping accommodations, the AMT might dictate which of the two is selected as the second residence. Although there is nothing in the Code that requires that the second residence for § 163 purposes to be the same second residence for AMT purposes, such a selection would avoid additional computation.

72. Sec. 56(b)(1)(c).

73. Sec. 56(e)(1).

74. Sec. 56(e)(2).

6. Points

Section 163 permits individuals to deduct some personal interest. The timing of the deduction is controlled by I.R.C. § 461.

Normally a cash method taxpayer would deduct interest when paid. However, § 461(g)(1) states that interest prepaid by a cash method taxpayer is deductible in the period to which it is allocated. In other words, both cash and accrual basis taxpayers treat interest expense in the same manner. Only the interest actually paid for the period within the tax year is deducted. The remainder is capitalized and deducted in a future period.

Section 461(g)(2) provides for an exception. Points paid by a cash method taxpayer "... in connection with the purchase or improvement of, and secured by, the principal residence of the taxpayer..." shall be deducted when paid, provided that points are generally charged in the taxpayer's geographic area and that amount is reasonable for that area. Although this exception was enacted in 1976, no regulations have been issued. As a result, there has been considerable litigation and uncertainty concerning this exception.

Section 163 allows an individual to deduct interest for a principal residence and a second residence. The exception in § 461(g)(2) for the deduction of points only applies to a principal residence. Although the section does not contain a definition of the term, it is reasonable to assume that it is identical to the definition used in § 163, which is that contained in § 1034. Recently, the Tax Court addressed one aspect of the definition in *Russell*.[75] In this case, the taxpayer deducted points for a loan on a home used partly as his principal residence and partly for rental purposes. The court concluded that the points were deductible since the property was used by the taxpayer as his residence. The court stated, "There is no exception in section 461(g) for a principal residence which is also used (partly or substantially) for rental purposes." Based on this decision, the taxpayer should be able to deduct points paid on a loan to purchase a duplex or even a quadplex, provided she uses part of the property as her principal residence.

Although the Code uses the term "points," it does not define it. One of the earliest uses of the term was in Rev. Rul. 67-297.[76] This Ruling uses the term as a synonym for loan origination fees charged by the Veteran's Administration. The fee was a percentage of the loan proceeds and was charged in lieu of separate fees for appraisals, notary fees, legal expenses, etc. Since the points were in lieu of fees, the Ruling concluded that they were not interest and, therefore, not deductible under § 163.

75. Russel v. Commissioner, T.C. Memo 1994-96, (U.S. Tax Ct. 1994).

76. 1967-2 CB 87.

The I.R.S. modified its position in Revenue Rulings 69-188[77] and 70-540.[78] In these Rulings, the Service recognized that sometimes a creditor will charge points which are in fact interest, while at other times the charge is for services rendered which are not interest. The Rulings concluded that points charged "... determined by the lender upon consideration of the factors that usually dictate an acceptable rate of interest" are deductible interest. There other charges (or points) that are non-deductible fees.

The distinction is not always clear. Therefore the Service issued Rev. Proc. 92-12[79] in an attempt to provide clarity. The revenue procedure covers items labeled as "points," "discount points," "loan discount," and "loan origination fees." In addition to being clearly labeled, the item must:

a) be shown on a uniform settlement statement such as HUD-1;
b) be computed as a percentage of the loan principal;
c) be charged as part of the normal business practice in the community;
d) be paid in connection with the acquisition of the principal residence of the taxpayer; and
e) be paid by the taxpayer.

To be paid by the taxpayer, she must provide cash that was not borrowed and is at least equal to the points. The cash can be used for deposit, escrow amounts, earnest money, or as partial payment of the purchase price.

Rev. Proc. 92-72 was modified by Rev. Proc. 94-27.[80] The modification extends the treatment provided to points paid by the seller, including points charged to the seller. In these cases, the taxpayer must still provide cash that is at least equal to the points. In addition, the taxpayer must reduce the purchase price (basis) of the residence by the points paid by the seller and claimed as a deduction.

Points paid by the taxpayer and not covered by these revenue procedures are still deductible under § 461, provided that the taxpayer can demonstrate that they meet the general definition of points. Included in these points are points paid on loans to improve the principal residence. Although § 461(g)(2) applies to loans for both acquisition and improvement, the revenue procedures only cover acquisition debt. Thus, there is no safe harbor for improvement loans.

To qualify for the special deduction rule of § 461(g)(2), the points must be paid by the taxpayer. Shortly after the passage of this provision, a ques-

77. 1969-1 CB 54.

78. 1970-2 CB 101.

79. 1992-1 CB 663.

80. 1994-1 CB 613. The procedure supersedes the modification made by Rev. Proc 92-12A, 1992-1 CB 664.

tion arose as to whether points withheld by the creditor on a discounted loan qualified as points paid. The Tax Court considered this issue in *Schubel*.[81] The court concluded that discounted points did not so qualify. The court pointed out that § 461(g)(2) is an exception to the general rule of § 461(g)(1). The general rule only applies to prepaid interest. Since discounted points are not prepaid, but rather paid when the loan is repaid, they do not come within the scope of § 461(g)(1) and, therefore, cannot qualify for special treatment under subsection (g)(2). In effect, the court concluded that § 461(g)(2) did not change the pre-existing rule that withheld interest is not considered paid.[82] This conclusion with respect to discounted points applies today. For this reason Rev. Proc. 92-12 and 94-27 require taxpayers to provide cash from non-borrowed sources in an amount at least equal to the points to qualify for the safe harbor. It is imperative that taxpayers fulfill this requirement because if they do not, not only will they not qualify under the revenue procedures, but also they will not qualify under the general rule of § 461(g)(2) which will result in a loss of the current deduction for the points.

Section 461(g)(2) allows a deduction for points paid "in connection with" the purchase or improvement of a principal residence. The scope of the phrase "in connection with" has been the object of considerable litigation and discussion for taxpayers who refinance home mortgages. The specific question is whether points paid on refinancing a home mortgage can be deducted under § 461(g)(2).

The government's position is spelled out in Rev. Rul. 87-22.[83] Section 461(g)(2) only applies to the purchase or improvement of a principal residence. Funds used for any other purpose do not qualify. A refinancing loan is used to pay off a prior debt and not to purchase a new residence. Therefore, the points are not eligible for this special treatment.[84] If the refinancing not only repays an existing loan, but funds an improvement to the residence, the portion of the points allocated to the funds used for the improvement can be deducted under § 461(g)(2).

In *Huntsman*[85] the taxpayer argued that Rev. Rul. 87-22 is incorrect and that the phrase "in connection with" is broad enough to encompass refinancing. In this case, the taxpayer paid points of $4,440 to refinance a three year

81. Schubel v. Commissioner, 77 TC 701 (1981).

82. *See* Rubnitz v. Commissioner, 67 TC 621 (1977) and Anover Realty Corp. v. Commissioner, 33 TC 677 (1960).

83. 87-1 CB 146.

84. The conclusion is based on a quote from the Committee reports to the 1976 Bill which states that proceeds used for purposes other than purchase or improvement of a home do not qualify.

85. Huntsman v. Commissioner, 91 TC 917 (1998).

balloon note with a 30-year mortgage. A majority of the Tax Court decided that the taxpayer's interpretation was incorrect. In a footnote, the court left open the possibility that refinancing of a construction or bridge loan might come within the meaning of "in connection with."

The Eighth Circuit Court of Appeals reversed the Tax Court.[86] The Eighth Circuit felt that the phrase "in connection with" should be interpreted broadly. To meet this test, the expenditure need only be in "association with" or "related" to the purchase of a residence. To deny all refinancing would in effect replace the "in connection with" phrase with a "directly related to the purchase" requirement. In *Huntsman*, the taxpayer's replacement of a 3-year balloon note with a 30-year mortgage is "in connection with" the purchase of the residence and, therefore, eligible for treatment under § 461(g)(2).

The decision in *Huntsman* appears to adopt the Tax Court decision rather than overrule it. If the taxpayer is refinancing a construction or bridge loan, it can be considered in connection with the purchase of the residence. If the taxpayer is refinancing a long-term mortgage with another long-term mortgage to reduce the interest rate, it will not qualify as being in connection with the purchase. Although most construction loans are self-evident, the length of a qualifying bridge loan has yet to be decided.

In 1991, the I.R.S. issued an 'Action on Decision' on *Huntsman*. In this pronouncement, the Service decided not to request *certiorari* due to an absence of conflict in the circuits, but rather to maintain the position that refinancing does not qualify for § 461(g)(2) in all circuits other than the Eighth.

In *Fort Howard Corporation*,[87] the Tax Court was asked to reconsider its decision in *Huntsman*. After reviewing the facts, the court found that the loan in *Fort Howard* was a construction/bridge loan. The court therefore felt that the current case did not require a reconsideration of their prior decision. By refusing to reconsider its prior decision, the Tax Court appeared to endorse the conclusion of the Eighth Circuit that certain limited refinancing can qualify under § 461(g)(2). The real difference appears to be in the definition of the terms "construction" and "bridge" loans. The Court of Appeals felt that *Huntsman* refinanced a bridge loan whereas the Tax Court felt differently. It is reasonable to assume that there will be additional litigation on this issue.

Section 461(g)(2) allows an immediate deduction for points. For points paid in connection with loans whose interest is deductible under § 163, but not currently deductible under § 461(g)(2), the points must be amortized over the life of the loan. The general rules for computation are contained in I.R.C. § 1272(a) and require amortization based on economic accrual of the points

86. 905 F.2d 1182 (8th Cir. 1990).
87. 103 TC 345 (1994).

as if they were an original issue discount. To ease the burden on taxpayers, Rev. Proc. 87-15[88] provides a short cut method for certain taxpayers. Under this revenue procedure, the points may be allocated ratably over the loan period. To use this revenue procedure, the following condition must be met:

1. the borrower is an individual;
2. she uses the cash method of accounting;
3. the loan period does not exceed thirty years; and
4. if the loan term exceeds ten years, then
   a) the principal cannot exceed $250,000 or
   b) the points are four or less for fifteen years on shorter loans and six or less for longer loans.

The use of the revenue procedure not only simplifies the computation, but also accelerates part of the deduction. Therefore, it should be used when available.

E. Conclusion

Section 163(d) disallows a deduction for most personal interest. There is an exception for interest incurred in a trade or business. For this purpose, an employee is not considered engaged a trade or business. Recent decisions have held that loans to buy stock are not business, but rather investment, loans regardless of taxpayer's motive, whereas loans to buy an interest in a pass-through entity may generate deductible business interest.

The law allows individuals to deduct investment interest. It also allows taxpayers to increase this limit by electing to treat capital gains as investment income. To the extent the taxpayer makes this election, the gain is ineligible for the reduced capital gain tax rate. In most cases, taxpayers should not make this election.

The law also allows a deduction of interest on taxpayers' residences. This can include contiguous land purchased after, but used as part of, the residence purchase. Taxpayers can elect to treat the debt on a second residence as qualifying or elect to treat otherwise qualifying debt as non-residential debt. If taxpayers incur points to purchase the residence, the points may currently be deducted. There is a conflict as to the deductibility of points paid on a refinancing.

With proper planning taxpayers can maximize this deduction. However, many questions remain unanswered.

88. 1987-1 CB 624.