Notice 88-74, 1988-2 CB 385

Home Mortgage Interest

This notice provides guidance on various issues relating to the home mortgage interest deduction under section 163 (h) (3) of the Internal Revenue Code as revised by the Revenue Act of 1987 for taxable years beginning after December 31, 1987.

Section 163(h)(2) provides that qualified residence interest is deductible without regard to the limitation on personal interest. Qualified residence interest is interest paid or accrued during the taxable year on acquisition indebtedness or home equity indebtedness with respect to a qualified residence of the taxpayer. The aggregate amount of acquisition indebtedness is limited to $1,000,000 ($500,000 in the case of a married individual filing a separate return) and the aggregate amount of home equity indebtedness is limited to $100,000 ($50,000 in the case of a married individual filing a separate return).

TREATMENT OF PRE-OCTOBER 13 INDEBTEDNESS

Section 163 (h) (3) also provides special rules with respect to debt incurred and secured by a qualified residence on or before October 13, 1987, and debt incurred to refinance such debt (pre-October 13 indebtedness). In general, pre-October 13 indebtedness is treated as acquisition indebtedness and is not subject to the $1,000,000 limitation on other acquisition indebtedness. The aggregate amount of any pre-October 13 indebtedness does, however, reduce the amount of the $1,000,000 limitation allowed for other acquisition indebtedness.

DEFINITION OF ACQUISITION INDEBTEDNESS

Section 163 (h) (3) (B) provides that the term acquisition indebtedness means debt (1) which is incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer, and (2) which is secured by such qualified residence. Regulations will provide that debt may qualify as incurred in acquiring, constructing, or substantially improving a residence either under the tracing rules of section 1.163-8T, or under rules described below relating to debt incurred within 90 days before or after certain dates (debt qualifying under the 90-day rules). Under the regulations, the determination of whether debt is incurred in acquiring, constructing or substantially improving a residence will be made independently of the determination of whether debt is secured by the residence and without regard to whether the residence is a qualified residence as of the time the expenditures are made or the debt is incurred. Thus, for example, a debt incurred in acquiring a qualified residence which is not initially secured by the residence, may become acquisition indebtedness at the time the debt is subsequently secured by the qualified residence. Additionally, a debt incurred in acquiring a property that is not a qualified residence at the time the debt is incurred may become acquisition debt at the time the property subsequently becomes a qualified residence (assuming the debt is secured by the qualified residence).

DEBT QUALIFYING UNDER THE TRACING RULES OF SECTION 1.163-8T

Regulations will provide for purposes of section 163 that a debt may be treated as incurred in acquiring, constructing, or substantially improving a residence of the taxpayer to the extent that the proceeds of the debt are used, within the meaning of section 1.163-8T, to acquire, construct or substantially improve the residence.

DEBT QUALIFYING UNDER THE 90-DAY RULES

Notwithstanding the tracing rules of section 1.163- 8T, in the case of the acquisition of a residence, debt may be treated as incurred to acquire the residence to the extent of expenditures to acquire the residence made within 90 days before or after the date that the debt is incurred.

In the case of the construction or substantial improvement of a residence, debt incurred prior to the time the residence or improvement is complete may be treated as being incurred to construct or improve the residence to the extent of any expenditures to construct or improve the residence which are made no more than 24 months prior to the date that the debt is incurred. Debt incurred after the residence or improvement is complete, but no later than the date 90 days after such date, may be treated as being incurred to construct or improve the residence to the extent of any expenditures to construct or improve the residence which are made within the period beginning 24 months prior to the date the residence or improvement is complete and ending on the date the debt is incurred.

Whether a residence or an improvement is complete depends upon all the facts and circumstances.

For purposes of determining whether debt is incurred to acquire, construct or substantially improve a residence, debt is incurred on the date that the loan proceeds are disbursed to or for the benefit of the taxpayer (i.e., generally the loan closing date). The taxpayer, however, may treat the debt as being incurred on the date that a written application is made to incur the debt, but only to the extent that the debt proceeds are actually disbursed within a reasonable time after approval of the application. Debt proceeds disbursed within thirty days after approval of the application are considered**<Page 386>** disbursed within a reasonable time after approval of the application. Regulations will provide that if a written application is made for a debt within the requisite time period and the application is rejected, a reasonable additional time will be allowed to make a new application for such debt. The rule that a taxpayer may treat debt as being incurred on the date that a written application is made to incur the debt does not apply, however, for purposes of determining if debt is pre-October 13 indebtedness.

REFINANCING OF DEBT INCURRED TO ACQUIRE, CONSTRUCT OR SUBSTANTIALLY IMPROVE A RESIDENCE

If a taxpayer incurs a debt which is treated as incurred to acquire, construct or substantially improve a residence under these rules, and subsequently incurs a second debt, the second debt may be treated as incurred to acquire, construct or substantially improve the residence if the proceeds of the second debt are used within the meaning of section 1.163-8T to refinance the first debt.

OTHER GENERAL RULES RELATING TO ACQUISITION INDEBTEDNESS

The total amount of debt which may be treated as debt incurred in acquiring, constructing or substantially improving a residence may not exceed the cost of the residence (including the cost of any improvements).

Taxpayers are reminded that, even though debt may be incurred in acquiring, constructing or substantially improving a qualified residence, the debt will not qualify as acquisition indebtedness until the debt is secured by the qualified residence. Regulation section 1.163- 10T provides that a taxpayer may treat a residence under construction as a qualified residence for a period of up to 24 months, provided the residence becomes a qualified residence as of the time the residence is ready for occupancy.

TREATMENT OF DEBT WHICH IS PARTIALLY ACQUISITION INDEBTEDNESS AND PARTIALLY HOME EQUITY INDEBTEDNESS

Regulations will provide that a single debt may qualify as partially acquisition and partially home equity indebtedness. Therefore, for example, if a taxpayer incurs a debt secured by his qualified residence and uses a portion of the debt proceeds to refinance an existing acquisition indebtedness and uses the remaining portion of the debt proceeds for purposes other than the substantial improvement of the residence, the portion of the debt used to refinance the acquisition indebtedness will qualify as acquisition indebtedness and the portion of the debt used for other purposes will generally qualify as home equity indebtedness, subject to the $100,000 limitation on home equity indebtedness.

EXAMPLES

The following examples illustrate the application of the preceding rules.

Example 1. T incurs a debt of $100,000, the proceeds of which are used within the meaning of section 1.163-8T, to purchase a residential lot on January 15, 1989. The debt is secured by the lot. On January 1, 1990, T begins construction of a residence on the lot. T spends $250,000 of unborrowed funds to construct the residence. The residence is complete on December 31, 1991, and, at that time, the residence becomes T's principal residence. On March 15, 1992, T incurs a debt of $300,000 secured by the residence. The lender on the second debt disburses $100,000 to pay off the existing debt, and disburses the remaining $200,000 directly to T. T has no other debt secured by a qualified residence.

The $100,000 debt that was incurred in 1989 is incurred to construct the residence because the proceeds of the debt are directly traceable to expenditures to construct the residence (i.e., the purchase of the lot). During the period January 15, 1989, through December 31, 1989, T may not treat the debt as acquisition indebtedness because it is not secured by a qualified residence. During the period January, 1990, through December 30, 1991, T may treat the residence under construction as a qualified residence. See section 1.163-10T(p)(5). Accordingly, the debt may qualify as acquisition indebtedness. During the period December 31, 1991, through March 15, 1992, the residence is a qualified residence and the debt will qualify as acquisition indebtedness.

The $300,000 debt is also incurred to construct the residence. $100,000 of the debt is treated as debt incurred to construct the residence because was used to refinance debt incurred to construct the residence; the remaining $200,000 of the debt is treated as debt incurred to construct the residence because it was incurred within 90 days after the residence was complete, and construction expenditures of at least such an amount were incurred within the period beginning with the date 24 months prior to the date the residence was complete and ending with the date the debt was incurred. The entire $300,000 debt is acquisition indebtedness because it is also secured by a qualified residence. Therefore, all of the interest on the debt is deductible as qualified residence interest.

Example 2. The facts are the same as in example (1), except that rather than incurring a debt to purchase the lot, T uses cash to purchase the lot. In this case, since none of the $300,000 debt was used to refinance a debt incurred to construct a qualified residence, the debt may be treated as incurred to construct the residence only to the extent of the $250,000 in expenditures that were incurred during the period beginning on the date 24 months prior to the date the residence was complete, and ending on the date the debt was incurred. The expenditure to purchase the lot was made prior to that period and, accordingly, the debt may not be treated as incurred to pay for that expenditure.

Accordingly, $250,000 of the debt incurred on March 15, 1992, may be treated as incurred to construct the residence and, therefore, will qualify as acquisition debt. Because the debt is secured by a qualified residence, the remaining $50,000 of the debt will qualify as home equity indebtedness. Therefore, all of the interest on the $300,000 debt is deductible as qualified residence interest.

TREATMENT OF DEBT INCURRED TO ACQUIRE AN INTEREST IN A RESIDENCE INCIDENT TO DIVORCE

Regulations will also provide that, in general, debt incurred to acquire the interest of a spouse or former spouse in a residence, incident to a divorce or legal separation, will be eligible to be treated as debt incurred in acquiring a residence for purposes of section 163, without regard to the treatment of the transaction under section 1041 of the Internal Revenue Code.

ADMINISTRATIVE PRONOUNCEMENT

This announcement serves as an “administrative pronouncement” as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.