DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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June 18, 2001

Number: **200137033**
Release Date: 9/14/2001
CC:ITA:3/TL-N-7243-00
UILC: 163.06-04

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Douglas A. Fahey,
Assistant to the Branch Chief CC:ITA:3

SUBJECT: Mortgage Interest - Multiple Residences

This Chief Counsel Advice responds to your memorandum dated January 19, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

organization =
x =
year 1 =
date 1 =
date 2 =
date 3 =
date 4 =
date 5 =
date 6 =
date 7 =
State A =
State B =
amount 1 =
amount 2 =
amount 3 =
amount 4 =
amount 5 =
amount 6 =
amount 7 =

ISSUES

1. Whether taxpayers, a married couple filing jointly, are entitled to claim mortgage interest deductions for a principal residence and one other residence for a time period during which they lived in a third residence provided to them by organization.

2. What is the amount of the mortgage interest deduction(s), if any, to which taxpayers are entitled?

CONCLUSIONS

1. Taxpayers are entitled to claim deductions for mortgage interest paid on loans for their principal residence and one other residence under § 163(h). Which of the three residences at issue was taxpayers' principal residence during year 1 is a factual determination to be made based on all the relevant facts and circumstances. Once taxpayers' principal residence has been determined, taxpayers may select another residence to treat as their "other" residence for purposes of the mortgage interest deduction.

2. Taxpayers are entitled to a deduction for any interest paid on home acquisition loans totaling $1 million on their principal residence and one other residence. Taxpayers are further entitled to a deduction for any interest paid on home equity loans totaling $100,000 on their principal residence plus one other residence.

FACTS

As we understand the facts, taxpayers are a married couple who filed a joint return for year 1. (Taxpayers are referred to individually as "H" and "W" as appropriate below.) On their year 1 return, taxpayers claimed mortgage interest deductions for two residences, one in State A and one in State B in the total amount of amount 1. W and W's family member held the legal title to the residence in State A during all of year 1. The highest principal balance on the loan secured by the State A residence during year 1 was amount 2, and the balance was amount 3 on date 5. On their year 1 return, taxpayers claimed a deduction in the amount of amount 4 for interest paid on this loan (rounded up from amount 5).[1] Only W is listed as a borrower by the mortgage company. Taxpayers purchased the residence in State B on date 4. Taxpayers own this home jointly, and both are listed as borrowers by the mortgage company. The principal amount of the acquisition loan was amount 6, and the terms of this loan call for payments of interest only during year 1. Taxpayers claimed an amount 7 deduction for interest paid on this loan on their year 1 return. For purposes of this memorandum, we assume that both mortgages are secured by the respective residences.

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[1] Taxpayers have not provided any information concerning whether this loan is "home equity indebtedness," as opposed to "home acquisition indebtedness." The field presumes it is home equity indebtedness.

From date 1 until date 6, taxpayers lived in a third residence provided to them by organization in connection with H's job. Nevertheless, taxpayers contend that they "consistently" treated the residence in State A as their principal residence during this time period, which includes year 1. They further contend that the residence in State B is their "other" residence for purposes of § 163(h)(4). We have not been provided with any facts concerning the amount of time taxpayers spent in the State A or third residence until the time the State B residence was purchased, or the amount of time taxpayers spent in each of the three residences after that. The field states that neither the State A residence nor the State B residence was leased, or made available for lease, during year 1.

LAW AND ANALYSIS

Section 163(a) of the Internal Revenue Code generally allows a deduction for all interest paid or accrued within the taxable year on indebtedness. An exception to the general rule is provided in § 163(h), which for taxpayers other than corporations disallows a deduction for personal interest. Section 163(h)(2)(D), however, provides that personal interest does not include qualified residence interest within the meaning of § 163(h)(3). Thus, taxpayers other than corporations may deduct qualified residence interest.

Under § 163(h)(3), the term "qualified residence interest" means any interest which is paid or accrued during the taxable year on either acquisition indebtedness or home equity indebtedness with respect to any qualified residence of the taxpayer. Acquisition indebtedness is any indebtedness that is (1) incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and (2) secured by the residence. The aggregate amount of acquisition indebtedness for any period is limited to $ 1,000,000, or $ 500,000 in the case of a married individual filing a separate return. Home equity indebtedness is any indebtedness (other than acquisition indebtedness) that is secured by a qualified residence to the extent the aggregate amount of the indebtedness does not exceed the fair market value of the qualified residence, reduced by the amount of acquisition indebtedness of the residence. The aggregate amount of home equity indebtedness for any period is limited to $ 100,000, or $ 50,000 in the case of a married individual filing a separate return.

Section 163(h)(4)(A) defines "qualified residence" as a taxpayer's principal residence, within the meaning of § 121, and one other residence that the taxpayer selects for this purpose and uses as a residence, within the meaning of § 280A(d)(1). In the case of married individuals filing separate returns, § 163(h)(4)(A)(ii) provides that the couple shall be treated as one taxpayer for purposes of determining "principal residence" and "one other residence" within the meaning of "qualified residence." Furthermore, each individual may take into account only one residence unless both individuals consent in writing to one individual taking into account the principal residence and one other residence.

Based on the facts described above, four questions arise with respect to application of § 163(h) in the instant situation: (1) to what extent are taxpayers entitled to claim a mortgage interest deduction; (2) what constitutes the taxpayers' "principal" residence; (3) whether the residence in State A or State B constitutes an "other residence;" and (4) what is the amount of the allowable mortgage interest deduction, if any. Each of these issues is discussed separately below.

To What Extent are Taxpayers Entitled to Claim a Mortgage Interest Deduction

Section 1.163-1(b) of the Income Tax Regulations provides that a taxpayer may deduct interest on a mortgage "upon real estate of which he is the legal or equitable owner." See also Mills v. Commissioner, T.C. Memo. 1999-60. Further, the person entitled to deduct interest is the person who is legally liable to pay the interest. See e.g., Arcade Realty Co. v. Commissioner, 35 T.C. 256 (1960), acq. 1961-1 C.B. 3; Rev. Rul. 64-31, 1964-1 C.B. 300. Additionally, a deduction with respect to a joint obligation is allowable to the party who makes the payment out of his own funds. Mills v. Commissioner; Finney v. Commissioner, T.C. Memo. 1976-329.

Section 163(h) places further restrictions on the deduction of interest expense by taxpayers other than corporations. That provision essentially defines all interest expense as nondeductible personal interest, unless it is of a type specifically excepted under § 163(h)(2). "Qualified residence interest" is one of those exceptions. As discussed above, § 163(h)(4)(A) defines "qualified residence" as a taxpayer's principal residence plus one other residence. This subsection discusses the principal residence "of a taxpayer," but does not explicitly state whether a married couple filing jointly is treated as one taxpayer or two. Thus, the statute is silent on the issue of whether a married couple filing jointly is treated as one taxpayer, who may only have one principal residence and one other residence for both spouses, or whether each spouse may have his or her own separate principal residence plus his or her own separate other residence. This issue is important where, as here, a married couple filing jointly owns two residences and lives in a third residence for a substantial portion of time, because § 163(h)(4)(A) clearly limits "a taxpayer's" mortgage interest deduction to interest paid on a principal residence and one other residence.

Section 163(h)(4)(A)(ii)(I) provides that married individuals filing separately are "treated as 1 taxpayer for purposes of clause (i)." "Clause (i)" is a reference to § 163(h)(4)(A)(i), which defines a qualified residence as a taxpayer's principal residence (§ 163(h)(4)(A)(i)(I)) plus one other residence (§ 163(h)(4)(A)(i)(II)). The next subsection provides that if married individuals file separately, they are each "entitled to take into account 1 residence unless both individuals consent in writing to 1 individual taking into account the principal residence and 1 other residence." § 163(h)(4)(A)(ii)(II). Thus, a married couple filing separately is treated as one taxpayer for purposes of determining the couple's qualified residence, and their

combined mortgage interest deduction is limited to interest paid on one principal residence and one other residence.

Although for purposes of § 163(h)(4)(A) two married individuals typically have one common principal residence, it is possible that under appropriate facts and circumstances, each spouse may have his or her own, separate principal residence (e.g., the facts and circumstances establish that H's principal residence is in one location but W's principal residence is in another). If two married individuals who are found to have separate principal residences also own a third residence, an issue may arise concerning which two of the three residences constitute the couple's "qualified residence" (principal residence plus one other residence) for purposes of the mortgage interest deduction. Section 163 and the temporary regulations are silent as to how such a couple would determine their principal residence and one other residence. In the absence of regulations, we believe it appropriate for such a couple to select one of the principal residences as their "principal" residence, and either the other principal residence or the third residence as their "other" residence.

Although § 163(h)(4)(A) does not specifically state that a married couple filing jointly is treated as one taxpayer for purposes of determining their mortgage interest deductions, we assume that Congress did not intend to treat married couples filing jointly differently than married couples filing separately. Thus, a married couple filing jointly would also be treated as one taxpayer and would be entitled to take into account only a principal residence and one other residence for purposes of calculating their mortgage interest deduction.

Accordingly, as married individuals filing jointly, the taxpayers here are treated as "1 taxpayer" for purposes of determining the residences they may take into account for purposes of the mortgage interest deduction. Because one, or both, are the legal owners of the State A and State B residences and also liable on the relevant loans, the next questions are what constitutes their principal residence and other residence, as discussed below.

<u>Taxpayers' Principal Residence</u>

Section 163(h)(4)(A) provides that "principal residence" has the same meaning as it does in § 121. Section 121, which provides rules for the exclusion of gain from the sale or exchange of a taxpayer's principal residence, does not define "principal residence" either. Section 1.121-1(b) of the recently proposed Income Tax Regulations provides:

> whether or not property is used by the taxpayer as the taxpayer's residence, and whether or not property is used by the taxpayer as the taxpayer's principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances. If a taxpayer alternates between two properties, using

> each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence.

§ 1.121-1(b) of the Proposed Income Tax Regulations (65 Fed. Reg. 196).

Most of the case law concerning what constitutes a taxpayer's principal residence arose under former § 1034, the predecessor of § 121, which provided for the rollover of gain from the sale or exchange of a taxpayer's principal residence. Like § 121, the former § 1034 did not specifically define "principal residence." Like the newly proposed regulations under § 121, the cases decided under former § 1034 apply a facts and circumstances test to taxpayers who use more than one property as a residence during a tax year.

In Thomas v. Commissioner, 92 T.C. 206 (1989), the issue was whether the sale of taxpayers' residence in Illinois constituted the sale of their principal residence, so that they could defer the resulting gain under § 1034. In the four years preceding the sale, taxpayers had spent approximately one-half of their time at the Illinois residence and the other half at three separate residences in Florida. The court held that the relevant factors to consider are: (1) the amount of time taxpayers spent at one residence as opposed to the other(s); (2) whether taxpayers abandoned the Illinois residence with the intent not to return and whether taxpayers' nonuse of the Illinois residence was substantial from the time they left it; and (3) whether a temporary rental of the Illinois residence was necessitated because of an adverse real estate market (as opposed to converting the Illinois residence into a nontemporary rental for the production of income). The court then looked at the facts and noted that taxpayers had spent one-half of their time at the Illinois residence, taxpayer husband's business had remained in Illinois, both taxpayers filed Illinois state income tax returns as full-year residents, and taxpayer wife contributed to and attended church in Illinois for three of the four years, and had only an Illinois driver's license. Based on these facts, the court held that the Illinois residence remained taxpayers' principal residence until the time of the sale.

In Rev. Rul. 77-298, 1977-2 C.B. 308, the Service held that a member of Congress' principal residence was his home in the Washington, D.C. area where the taxpayer had lived for eight years and spent the majority of time in that home. The taxpayer also owned a residence in his home district and used it for visits there. The Service held that, where a taxpayer alternates between two properties, physically occupying each as a residence for successive periods of time, the property that the taxpayer occupies a majority of the time will ordinarily be considered his principal residence for purposes of § 1034. Accordingly, the taxpayer was permitted to defer gain on the sale of the Washington, D.C. home by rolling it over through the purchase of another principal residence.

Based on the above authorities, which residence constitutes taxpayers' principal residence in the instant case depends on all the facts and circumstances.

Under the proposed regulations and Rev. Rul. 77-298, the determination would be based on where they resided the majority of the time during year 1. As in Thomas, additional factors to consider include the taxpayers' intent, location of their employment, where they file state tax returns, and what state or municipality issued their driver's licenses.[2]

A newly-purchased residence, such as the State B residence, must be physically occupied to constitute a principal residence. See, e.g., United States v. Shehan, 323 F.2d 383 (5th Cir. 1963). The test of physical occupancy is not satisfied by merely moving furniture or other personal belongings into the residence without actually occupying it. Bayley v. Commissioner, 37 T.C. 288 (1960), acq. 1961-1 C.B. 4. Additionally, token use of a new residence, such as on weekends or vacations, has been held insufficient to satisfy the requirements of a principal residence. Stolk v. Commissioner, 40 T.C. 345 (1963), acq. 1964-2 C.B. 7, aff'd, 326 F.2d 760 (2d Cir. 1964).

Taxpayers' Other Residence

Section 163(h)(4)(A) provides that a taxpayer may claim a mortgage interest deduction for his principal residence and "one other residence." The one other residence is any residence "used by the taxpayer as a residence" within the meaning of § 280A(d)(1). Section 280A(d)(1) provides that a taxpayer uses a dwelling as a residence if he uses it during the tax year for personal purposes for the greater of fourteen days or 10% of the number of days it is rented a fair rental. If the residence is not rented at any time during the tax year, then it may be treated

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[2] We note that taxpayers contend they have "consistently" treated the State A residence as their joint principal residence. In several instances, courts have applied a "temporary absence exception" to hold that residences retained their character as principal residences, even though they were rented or otherwise not used by the taxpayers during the year at issue. See, e.g., Trisko v. Commissioner, 29 T.C. 515 (1957), acq. 1959-1 C.B. 5 (taxpayer and family moved to Europe for four years during taxpayer's foreign service appointment but retained their home in the United States); Barry v. Commissioner, T.C. Memo. 1971-179 (taxpayer's former residence remained his principal residence while taxpayer was required to live in military housing during the five final years of his military service); Rev. Rul. 78-146, 1978-1 C.B. 260 (applying the temporary absence exception to a taxpayer who accepted a two-year temporary work assignment in another city, who intended to return to his former home at the conclusion of the two years, but did not because of a change in the school system).

We have not been provided with any facts concerning whether taxpayers used the State A home as their principal residence up until the time they moved into the housing provided with H's job in date 1, and, if so, whether or not they intended to move back into that residence at the conclusion of H's job in date 6. Accordingly, we are unable to comment on the applicability of such an exception to taxpayers' situation.

as a “residence” within the meaning of § 163(h)(4), regardless of how often the taxpayer uses it for personal purposes. § 163(h)(4)(A)(iii).

Further, § 1.163-10T(p)(3)(iv) provides that a taxpayer may only select one residence as a “second residence” during a single tax year, except that a taxpayer who purchases another residence during the tax year may elect the new residence as the “second residence” as of the date of acquisition.

The field states that neither the State A residence nor the State B residence was leased or offered for lease during year 1. Thus, taxpayers could elect to treat either residence as their other residence for periods of actual ownership during year 1. Taxpayers may select the State A residence as their other residence for all of year 1, or they may select the State A residence from date 2 through date 3, and then select the State B residence as of the date of acquisition, date 4, through the end of year 1.

To conclude the discussion of principal and other residences, which residence constitutes taxpayers’ principal residence during year 1 depends upon all the facts and circumstances. Once a determination of taxpayers’ principal residence has been made, then taxpayers may select another residence, within the perimeters discussed above, to be treated as their “other” residence. If the third residence (the one provided in connection with H’s job) is their principal residence, then taxpayers have two options concerning their other residence. First, they may select the State A residence as their other residence for year 1. Second, they may select the State A residence as their other residence from date 1 through date 3, and then select the State B residence as their other residence from date 4, the date of acquisition, through the end of year 1. Finally, if either the State A or State B residence is their principal residence, then taxpayers may select the remaining residence as their other residence during year 1.

<u>What is the Allowable Amount of Mortgage Interest Deduction</u>

Assuming the interest paid on mortgages for either or both the State A and State B residences may constitute “qualified residence interest” within the meaning of § 163(h)(3), the final issue is what amount is properly allowable as a mortgage interest deduction for year 1.

Section 163(h)(3)(B)(ii) limits the aggregate amount of home acquisition indebtedness for any taxpayer to $1,000,000, or $500,000 in the case of a married taxpayer filing separately. Therefore, interest on any portion of a home acquisition loan, or loans, in excess of $1,000,000 is not deductible as qualified residence interest. Section 163(h)(3)(C)(ii) limits the aggregate amount of home equity indebtedness for any taxpayer to $100,000, or $50,000 in the case of a married taxpayer filing separately. Therefore, interest on any portion of a home equity loan, or loans, in excess of $100,000 is not allowed as a deduction. Under these provisions, the maximum amount of outstanding loans which a taxpayer, other than

a married individual filing separately, may take into account for purposes of calculating a mortgage interest deduction is up to $1,000,000 for acquisition indebtedness and up to $100,000 for home equity indebtedness on the taxpayer's qualified residence.

Here, if both loans are acquisition loans, then the aggregate amount of taxpayers' debt is in excess of the $1 million limit of § 163(h)(3)(B)(ii) for any period during year 1 when both the State A residence and the State B residence constituted qualified residences (from date 4 through date 5). Further, if only the State B loan is an acquisition loan, then the aggregate amount of taxpayers' acquisition debt is still in excess of the limit (see discussion of average daily balance below).[3] Taxpayers are only entitled to a deduction for interest paid on $1 million of acquisition debt. See Pau v. Commissioner, T.C. Memo. 1997-43 (married couple filing jointly only entitled to a deduction for interest attributable to first $1 million of their home acquisition loan where outstanding principal balance was $1,330,000).

In their date 7 submission, taxpayers' representatives use a formula provided in the regulations to argue that the aggregate amount of taxpayers' debt is not in excess of the $1 million limit. The formula used by taxpayers' representatives is found in § 1.163-10T(h)(3), average balance computed on a daily basis. As a preliminary matter, we note that subsections (b) through (h) of § 1.163-10T were drafted pursuant to the 1986 version of the statute, which provided that the amount of deductible "qualified residence interest" was limited to the fair market value of the residence securing the debt. See § 163(h)(3)(B) (1986). This subsection was amended in 1987 to provide the $1 million aggregate limit now found in § 163(h)(3)(B)(ii). Accordingly, subsections (b) through (h) of the regulation provide several methods for calculating the amount of allowable interest deduction under the strictures of a different definition of "qualified residence interest."

Notwithstanding the above, computing the average balance of outstanding home acquisition loans is a permissible method of determining whether a taxpayer's loans exceed the present $1 million limit. See Publication 936, Home Mortgage Interest Deduction. Here, taxpayers attempted to use an average daily balance formula to determine their average balance on the State B loan. Although an average daily balance formula is permissible, taxpayers used an incorrect figure in the formula found in § 1.163-10T(h)(3)(ii). Apparently, taxpayers added the daily balance for each day the State B loan was outstanding in year 1 (*x* days), and then divided the sum by 365. However, the sum must be divided by the number of days

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[3] Conversely, if only the State A residence constitutes a qualified residence, then all of the interest paid on that mortgage is deductible as qualified residence interest, because the outstanding balance of the loan is below the $1 million aggregate limit for acquisition indebtedness and also below the $100,000 limit for home equity indebtedness.

the residence is a qualified residence during the tax year. The example in § 1.163-10T(h)(3)(ii) uses a divisor of 365, but the fact pattern provides that the residence was the taxpayer's principal residence during the entire tax year. Here, in order to calculate their average daily balance, taxpayers would add the daily balance for each day the loan was outstanding (*x* days) and then divide the sum by the number of days the State B residence was a qualified residence during year 1 (a maximum of *x*, the number of days taxpayers owned the residence). Taxpayers would need to make the same calculation for the loan on the State A residence, and then add the average daily balances of both loans in order to determine whether the aggregate amount exceeds the permissible limit.

If the State A loan is a home equity loan, then the separate $100,000 limit found in § 163(h)(3)(C)(ii) applies to this indebtedness. Taxpayers would then be entitled to deduct qualified residence interest paid on up to $1 million of their acquisition loan for the State B residence, plus all of the interest paid on the home equity loan secured by the State A residence (the highest balance on the State A loan was amount 2 during year 1, which is below the $100,000 limit).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Please call of my office at if you have any further questions.

DOUGLAS A. FAHEY
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