Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200911007**
Release Date: 3/13/2009

CC:ITA:B01:NJLee
POSTS-136800-08

UILC: 163.06-01

date: November 24, 2008

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from: John P. Moriarty
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(Income Tax & Accounting)

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subject: Mortgage Interest Deduction (Limitation on Acquisition Indebtedness)

This Chief Counsel Advice responds to your request for assistance dated September 15, 2008. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Co-Owner =
Year 1 =
Year 2 =
Year 3 =
$U =
$V =
$W =
$X =
$Y =
$Z =
P% =
Q% =

ISSUE

How does the $1,000,000 limitation on aggregate acquisition indebtedness under § 163(h)(3)(B)(ii) of the Internal Revenue Code apply where Taxpayer is a partial owner of a residence for which the total acquisition indebtedness exceeds $1,000,000?

CONCLUSION

As discussed below, the $1,000,000 limitation on acquisition indebtedness under § 163(h)(3)(B)(ii) is used to determine the portion Taxpayer's interest payments that may be deducted. In particular, the amount of interest Taxpayer may deduct is determined by multiplying the amount of interest actually paid by Taxpayer on Taxpayer's qualified residence by a fraction the numerator of which is $1,000,000 and the denominator of which is $V, the average balance of the outstanding acquisition indebtedness during the years in question.

FACTS

During Year 1, Year 2 and Year 3, Taxpayer owned a principal residence (within the meaning of § 121) (Property). Prior to Year 1 Taxpayer acquired the property for $U and financed the acquisition by obtaining an interest-only loan in the amount of $V (Mortgage), secured by Property. Mortgage is an amount in excess of $1,000,000 and no part of Mortgage constitutes home equity indebtedness within the meaning of § 163(h)(3)(C). In Year 1, Taxpayer was the sole mortgagee of Mortgage, as reflected by a recorded deed of trust. In Year 2, Taxpayer transferred the property to himself and Co-owner as joint tenants. In addition, in Year 2, Co-Owner was added as an additional obligor on the Mortgage.[1] The facts indicate that, following the transfer of the property in Year 2, Taxpayer owned P% of the property and Co-Owner owned Q% of the Property.

It is our understanding that at all times during Years 1 through 3, inclusive, both Taxpayer and Co-Owner lived in the Property as their residence and neither Taxpayer nor Co-Owner owned an additional residence at any time during these years. Taxpayer paid all interest due on the Mortgage in Years 1 and 2. In particular, Taxpayer paid $W of interest in Year 1 and $X in Year 2; with respect to $1,000,000 of the Mortgage only $Y of interest was due in Year 1 and only $Z of interest was due in Year 2. Co-Owner did not pay any interest on the Mortgage in Years 1 or 2. In Year 3, it is our understanding that Taxpayer paid P% of all interest due on the Mortgage and Co-Owner paid Q% of all interest due on the Mortgage. Our analysis is based on these facts.

[1] This memorandum does not consider whether the Mortgage constitutes acquisition indebtedness as to Co-Owner because you have not asked about the ability of Co-Owner to deduct her payments.

LAW AND ANALYSIS

Under § 163(h)(1) of the Internal Revenue Code, in the case of a taxpayer other than a corporation, no deduction is allowed for personal interest paid or accrued during the taxable year. For purposes of § 163(h)(1), personal interest does not include any qualified residence interest within the meaning of § 163(h)(3). Sec. 163(h)(2)(D).

Under § 163(h)(3)(A), qualified residence interest means any interest paid or accrued during the taxable year on—

(i) acquisition indebtedness or
(ii) home equity indebtedness

with respect to any qualified residence of the taxpayer. For purposes of § 163(h)(3), a qualified residence is either the principal residence of the taxpayer (within the meaning of § 121) or one other residence of the taxpayer that is selected by the taxpayer for purposes of § 163(h) and that is used by the taxpayer as a residence (within the meaning of § 280A(d)(1)). Sec. 163(h)(4)(A)(i).

Acquisition indebtedness is defined as any indebtedness which is: (1) incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer and (2) secured by such qualified residence. Sec. 163(h)(3)(B)(i). Under § 163(h)(3)(B)(ii), the aggregate amount treated as acquisition indebtedness for any period is limited to $1,000,000 ($500,000 in the case of a married taxpayer filing a separate return). In this case, the amount of indebtedness incurred in acquiring Property and secured by Property exceeds $1,000,000.

Under § 1.163-1(b) of the Income Tax Regulations, interest actually paid by a taxpayer on a mortgage where the taxpayer is the legal or equitable owner of the underlying property may be deducted as interest on the taxpayer's indebtedness – even if the taxpayer is not directly liable on the bond or note secured by the mortgage.

Year 1 and Year 2

The aggregate amount of indebtedness on the Property that will be treated as acquisition indebtedness for purposes of the qualified residence interest deduction is limited to $1,000,000 of Mortgage. § 163(h)(3)(B)(ii). In Years 1 and 2, Taxpayer made all mortgage payments. Accordingly, Taxpayer is entitled to a deduction for qualified residence interest with respect to Property of $Y in Year 1 and $Z in Year 2 under § 163(h)(3).

Year 3

Taxpayer argues that the $1,000,000 limitation on acquisition indebtedness should be interpreted to allow a taxpayer to deduct the interest on up to $1,000,000 of indebtedness incurred in acquiring a qualified residence and for which taxpayer is personally liable and that Co-Owner also may deduct interest on up to $1,000,000 of additional acquisition indebtedness with respect to the same residence and for which Co-Owner is personally liable. The plain language of the statute does not support this interpretation.

Under § 163(h)(3)(B)(i), acquisition indebtedness is defined, in relevant part, as indebtedness incurred in acquiring a qualified residence of the taxpayer – not as indebtedness incurred in acquiring taxpayer's *portion* of a qualified residence. The entire amount of indebtedness incurred in acquiring the qualified residence constitutes "acquisition indebtedness" under § 163(h)(3)(A)(i). In this case, the amount of indebtedness incurred in acquiring Property exceeds $1,000,000. However, under § 163(h)(3)(B)(ii), the amount *treated* as acquisition indebtedness for purposes of the qualified residence interest deduction is limited to $1,000,000 of total, "aggregate" acquisition indebtedness.[2] This is evident from the parenthetical in § 163(h)(3)(B)(ii) which limits the aggregate treated as acquisition indebtedness to $500,000 for a married taxpayer filing a separate return.

Section 1.163-10T(e) explains how to determine the amount of deductible qualified residence interest when the secured debt exceeds the adjusted purchase price. If the average balance of the secured debt exceeds the applicable debt limit for that debt, the amount of qualified residence interest with respect to the debt is determined by multiplying the interest paid or accrued with respect to the debt by a fraction, the numerator of which is the applicable debt limit for that debt and the denominator of which is the average balance of the debt.[3] The applicable debt limit is defined in the regulations with respect to the situation where the secured debt exceeds the adjusted purchase price. In this case, Mortgage does not exceed the purchase price of Property; however, Mortgage does exceed the amount treated as acquisition indebtedness under § 163(h)(3)(B)(ii). Therefore, the applicable debt limit, for purposes of applying the regulations in this case, is the limitation under § 163(h)(3)(B)(ii) (i.e., $1,000,000).[4]

The secured debt (i.e., Mortgage) in this case exceeds the applicable debt limit for that debt (i.e., $1,000,000). Therefore, the amount of qualified residence interest with

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[2] For example, if a taxpayer paid interest with respect to indebtedness incurred in acquiring a principle residence under § 121 and a second residence under § 280A, the amount deductible as qualified residence interest is limited to $1,000,000 of the aggregate acquisition indebtedness incurred to acquire both residences.

[3] In this case, no average balance calculation is necessary because, during the years at issue, there was only one secured debt on which only interest payments were made.

[4] This calculation is described in Table 1 of Publication 936, *Home Mortgage Interest Deduction*, and its accompanying instructions.

respect to Mortgage in Year 3 is determined by multiplying the amount of interest paid by Taxpayer (i.e., P% of the interest due) in Year 3 by a fraction: $1,000,000 over the amount of Mortgage ($V).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Nancy J. Lee, Office of Chief Counsel (Income Tax and Accounting), at if you have any further questions.