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When Is Qualified Mortgage Interest Not Deductible?

-by Robert P. Achenbach, Jr., J.D.

A recent Washington District Court case¹ provides a reminder that not all qualified mortgage interest is deductible where the underlying mortgage debt becomes unenforceable against the taxpayer debtor.

Qualified Mortgage Interest

The 2017 increase in the standard deduction for married taxpayers to \$24,400 (in 2019) has lessened the benefits of the qualified mortgage interest deduction² for some taxpayers, although the deduction remains available for taxpayers with sufficient other Schedule A deductions.³

A personal deduction is allowed for qualified residence interest.⁴ Qualified residence interest is defined as interest on debt that is either “acquisition indebtedness” or “home equity indebtedness.”⁵ Acquisition indebtedness is debt incurred for the purpose of acquiring, constructing, or substantially improving either the principal residence or one other residence of the taxpayer selected by the taxpayer.⁶ The interest deduction is limited to only the first \$1,000,000 (\$500,000 for a married person filing a separate return) of qualified residence interest.⁷

A qualified residence is the principal residence⁸ and one other residence selected by the taxpayer and which is used as a residence.⁹ A qualified residence must be used by the taxpayer or a member of family for more than the greater of (1) 14 days or (2) 10 percent of the number of days when the residence is rented for a fair rent.¹⁰ Generally, the taxpayer must have a legal, equitable or beneficial interest in the residence.¹¹

Interest on Nonrecourse Debts

For a nonrecourse debt, the lender looks solely to the collateral for repayment in the event of a default. For a nonrecourse note to be sufficiently valid, i.e., the taxpayer is considered to be indebted on the note, to support a deduction for interest, the value of the collateral must equal or exceed the amount of the debt but not necessarily the entire purchase price.¹²

* Publisher and editor of the Agricultural Law Press.

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Most personal home mortgages are recourse notes where the taxpayer debtor is personally liable upon default for any deficiency remaining after foreclosure of the mortgage. However, what happens when that personal liability disappears, for example, where the mortgage is discharged in a bankruptcy case?

Milkovich v. United States¹³

In *Milkovich*, the taxpayers, husband and wife, owned a personal residence. The taxpayers defaulted on the mortgage and filed for Chapter 7 bankruptcy. The Chapter 7 trustee abandoned the property during the case because the taxpayers had no equity in the property. As a result of the bankruptcy, the taxpayers' personal liability for the mortgage debt was discharged, although the property itself remained subject to the mortgage.¹⁴

The residence was sold in 2011 at a short sale and the proceeds were applied by the mortgagee first to the accrued interest and the mortgagee issued a Form 1098-MIS stating that the mortgagee had received \$114,688 in interest from the taxpayers in 2011. The taxpayers dutifully declared a deduction for the mortgage interest on their 2011 tax return but the deduction was disallowed by the IRS. The taxpayers filed a timely appeal of the IRS decision.

The court cited *Estate of Franklin v. Commissioner*,¹⁵ for the rule, stated above, that when a nonrecourse liability exceeds a reasonable estimate of the fair market value of the indebted property, an otherwise allowable interest deduction is not allowed. The *Franklin* court reasoned that when a nonrecourse liability exceeds the fair market value of the collateral on a debt, the debt lacks economic substance: "[f]or debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for [the purchaser] to make a capital investment in the amount of the unpaid purchase price."¹⁶

The taxpayers attempted to argue that the interest was deductible because the mortgage holder issued Form 1098-MIS and the IRS was required to honor that information return. The court disagreed, noting that the taxpayers provided no authority for this argument.

Finally, the taxpayers argued that the *Franklin* holding did not apply in this case because *Franklin* involved a tax shelter. The court held that, although the *Franklin* case involved a tax shelter, the principle applied to discharged mortgage debts where the debtors' personal liability is discharged and the remaining debt exceeded the fair market value of the collateral.

In Conclusion

Clearly, the taxpayers were reaching too far to hope to claim a deduction for interest they did not pay and which arose only because the lender choose to allocate foreclosure proceeds to interest instead of principal on the mortgage.

The *Milkovich* case demonstrates that a personal qualified residential mortgage can be converted into essentially a non-debt, and what would be ordinarily deductible interest on the debt becomes nondeductible for lack of economic substance of the taxpayer's obligation on the debt.

ENDNOTES

¹ *Milkovich v. United States*, 2019 U.S. Dist. LEXIS 83720 (W.D. Wa. 2019).

² See Harl and Achenbach, *Agricultural Law*, § 28.06[4] (2019); Achenbach, *Farm Income Tax Manual*, § 3.05[5] (2019).

³ See Harl and Achenbach, *Agricultural Law*, Ch. 28 (2019); Achenbach, *Farm Income Tax Manual*, Ch. 3 (2019).

⁴ I.R.C. § 163(a), (h). The deduction for qualified residence interest is listed as an exception to the rule that personal interest is not deductible.

⁵ I.R.C. § 163(h)(3)(A).

⁶ I.R.C. § 163(h)(3)(B).

⁷ I.R.C. § 163(h)(3)(B)(ii).

⁸ The term "principal residence" has the same meaning as the term is used in I.R.C. § 121. I.R.C. § 163(h)(4)(A).

⁹ I.R.C. § 163(h)(4)(A).

¹⁰ I.R.C. § 163(h)(4)(A). If a family members rents the property for fair rent, that time is not counted toward the 10 percent.

¹¹ See *Daya v. Comm'r*, TC Memo 2000-360 (no mortgage interest and property tax deduction where no ownership of residence or equitable interest; deductions claimed on parent's home); *Hackley v. Comm'r*, T.C. Summary Op. 2002-19 (deductions denied for mortgage interest and real estate taxes for residence owned by sister); *Blanche, Jr. v. Comm'r*, T.C. Memo. 2001-63 (taxpayer who entered into earnest money contract with lease option for residence did not have sufficient benefits and burdens of ownership to claim interest deduction or property tax deduction; lacked legal or equitable title and was in possession as lessee); *Montoya v. Comm'r*, T.C. Summary Op. 2003-109 (interest on mother's mortgage not deductible; taxpayer was not holder of legal or equitable interest or liable on mortgage); *Wheeler v. Comm'r*, T.C. Summary Op. 2011-83 (no legal, equitable or beneficial interest in property so deduction denied for mortgage interest paid). But see *Uslu v. Comm'r*, T.C. Memo. 1997-551 (although mortgage debt incurred by taxpayer's brother, taxpayer and spouse had sufficient interest in residence where they lived in, possessed, and equitably owned the property and owed repayment to brother).

¹² See *Lebowitz v. Comm'r*, 917 F.2d 1314 (2d Cir. 1990) (interest deduction not jeopardized because payments timed to come out of profits of enterprise; taxpayer's nonrecourse obligation was genuine where value of security underlying note approximated amount of note); *Hildebrand v. Comm'r*, 967 F.2d 350 (9th Cir. 1992) (interest on nonrecourse debt not deductible where transaction was sham and lacked economic substance).

¹³ 2019 U.S. Dist. LEXIS 83720 (W.D. Wa. 2019).

¹⁴ See 11 U.S.C. § 524(a). See Harl and Achenbach, *Agricultural Law*, § 120.06[5] (2019).

¹⁵ 544 F.2d 1045 (9th Cir. 1976). See also *Hildebrand v. Comm'r*, 967 F.2d 350 (9th Cir. 1992) (interest on nonrecourse debt not deductible where transaction was sham and lacked economic substance).

¹⁶ 544 F.2d 1045, 1048 (9th Cir. 1976).