INTEREST EXPENSE DEDUCTIONS

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I. BASIC CATEGORIES OF INTEREST:

A. Personal Interest. All interest other than interest classified in one of the four categories below (§ 163(H)(2)) Personal interest is not deductible.

B. Investment Interest. Interest on indebtedness allocable to property held for investment (§ 163(d).

C. Passive Interest. Interest on indebtedness allocable to a passive activity as defined in § 499.

D. Qualified Residence Interest. Any interest that is either:

- Acquisition Indebtedness – (up to $1 million of debt ($500,000 if Married Filing Separate or grandfathered)

  Or
- Home equity indebtedness with respect to a qualified residence (§ 163(h)(3)) (up to $100,000 of equity ($50,000 if Married Filing Separate).

E. Business Interest. Interest attributable to a trade or business.

Note: Interest related to an employee activity is personal and no deduction is allowed (§ 163 (h)(2)(A)).

II. INTEREST TRACING

The general rule under Reg. § 1.163-8T(c)(1) is that debt is allocated to the proper category of interest incurred by the taxpayer by tracing disbursements of the debt proceeds to specific expenditures. The type of property that secures the debt does not impact the allocation except for home mortgage interest.

Example #1

Jody Somers borrowed $20,000 from her Dad. She used $15,000 to invest in a mutual fund. The other $5,000 she used to take her boyfriend on a Windjammer Cruise in the Caribbean. 75% of the interest is investment interest and 25% is personal interest.

A. Debt proceeds deposited into an account (§ 1.1630-8T(c)(4)) Debt proceeds that are deposited into a depositor's account that contains unborrowed funds are treated as being withdrawn first when expenditures are made.

When the proceeds of two or more loans are deposited into the same account, subsequent expenditures are treated as coming from the borrowed funds in the order in which they were deposited. This taxpayer may treat any expenditures made from any account or from cash, within 30 days before or 30 days after depositing borrowed funds as made from the debt deposited (Notice 89-35). In an account containing only the proceeds of a debt and the interest earned on these proceeds, the taxpayer may treat expenditures from the account as being made first from the interest earned.

Debt proceeds deposited into an account are treated as investment property until those funds are expended. The reallocation of expenditures occurs on the date of the expenditure but the taxpayer may elect:

1. To re-allocate the debt as of the first day of the month in which the expenditure occurs, or
2. To re-allocate the debt as of the day on which the debt proceeds are deposited into the account if later.

A taxpayer may use the first day of the month convention only if all other expenditures from the account during the month are similarly treated.

Example #2

Assume in Example #1 above that Jody borrowed the money on March 1, 2007 and immediately bought the $15,000 mutual fund. She did not pay for the cruise until June 1, 2007. She deposited the $5,000 in the bank and had no other transactions in that account. She also made no principal payments on the debt. The $5,000 is treated as being used for an investment purpose for the 3-month period. The total interest expense for 3 months on this debt is investment interest. In June, Jody must begin to allocate 75% of the debt as investment interest and 25% as personal.

Example #3

Date	**Transaction**		**Amount and Debt**
1/10/07	Deposit		$500 – DEBT A $1,000 – Unborrowed Funds
1/11/07	Deposit		$500 – DEBT B
2/05/07	Expenditure Expenditure		$800 – Personal $700 – Passive Activity
	Expense		From
	$800		$500 from DEBT A $300 from DEBT B
	$700		$200 from DEBT B $500 Unborrowed
GENERAL RULE			
Interest on Debt A -		Investment Personal	1/10/07 – 2/5/07 2/5/07 On
OPTIONAL RULE			
Interest on Debt A		Investment Personal	1/10/07 – 1/13/07 2/01/07 On
30 DAY RULE			
Could say $700 expended on 2/8/07:			$500 DEBT A $200 DEBT B $800 Personal ___ $300 DEBT B $500 Unborrowed Funds

The rules for allocation of debt apply separately to each account of the taxpayer.

B. Debt proceeds received in cash (§ 1.163-8T(c)(5)) Debt proceeds received in cash are treated as if they were used to make personal expenditures except that taxpayers may treat any expenditure made from any account or from cash within 30 days before or 30 days after debt proceeds are received in cash as made from the debt proceeds (Notice 89-35).

> **Note:** Debt proceeds are received in cash if cash is withdrawn from an account containing debt proceeds.

C. Debt Repayments. If at anytime any portion of a debt is repaid and such debt was allocated to more than one expenditure, the debt is treated as repaid in the following order:

1. Amounts allocated to personal expenditures.
2. Amounts allocated to investment expenditures and passive activity expenditures.
3. Amounts allocated to passive activity expenditures in connection with a rental real estate activity in which the taxpayer actively participated.
4. Amounts allocated to former passive activity expenditures.
5. Amounts allocated to active trade or business expenditures.

Example #4

If, in Example #2, Jody repays $1500 on November 1, 2008, the entire repayment is applied against the amount allocated to personal purposes. The debt balance is now allocated as $15,000 for investment purposes and $3,500 for personal purposes or $15,000/$18,500 (81%) is allocated to investment and 19% to personal.

D. What About a Credit Line? All borrowings on which interest accrues at the same rate are treated as a single debt. Borrowings on which interest accrues at different rates are treated as different debts and such debts are treated as repaid in the order such debts are treated as repaid under the loan agreement.

E. Election To Treat Debt Secured by a Qualified Residence as not Secured by the Residence (§ 1.163-10T(o)(5)).

Home mortgage interest is the exception to the rule that debt is allocated to the proper category of interest incurred by the tax payer using tracing rules. In the case of home mortgage interest, if the debt is secured by the home then the interest is qualified residence interest and if it is within the rules that apply to Qualified Residence interest, is deductible on Schedule A. However, the election noted above allows a taxpayer to treat debt secured by the residence as not secured by the residence.

Example

Jennifer owns a principal residence with a fair market value of $275,000 and an adjusted purchase price of $125,000. In 2007 debt A, the proceeds of which were used to purchase the residence, has an average balance of $100,000. This $100,000 is the original acquisition indebtedness. Jennifer has now applied for a credit line against her personal residence for an additional $125,000. The interest on home equity indebtedness is deductible on up to $100,000 of equity. If Jennifer uses $25,000 of the borrowed credit line money to buy inventory for her Schedule C business and elects under § 1.163-10T(o)(5)to treat this debt as not secured by the personal residence, she can trace these $25,000 in debt proceeds to her Schedule C business. This will allow for a full deduction of interest on the remaining $100,000 on Schedule A. In addition, she has an above the line deduction and also saves self-employment tax on the interest on the $25,000 loan.

F. Interest Tracing and Passthrough Entities (Notice 89-35)

IRS notice 89-35 provides guidance for tax years ending after December 31, 1987 (until regulations are published).

G. Purchase of an Interest in a Passthrough Entity.

The acquisition of an interest in a passthrough (i.e., the taxpayer borrowed to purchase an interest from either a shareholder or partner) must be allocated based upon the aspects of the entity using any reasonable method. Reasonable methods include pro-rata allocations based on FMV, book value or adjusted basis of the assets reduced by any debt of the passthrough's entity or the owner allocated to such assets.

H. Contribution of Capital.

If, instead of a purchase (as above), there is a contribution of capital debt is allocated using any reasonable method. Reasonable methods include allocating debt among all the assets or tracing the debt to the expenditures of the entity.

I. Tax Preparation Point. Once interest expense has been allocated for the passthrough, the expense is reported in the appropriate places on the Form 1040. For example: interest expense allocable to a passive activity is entered on Form 8582; interest expense allocable to a trade or business is reported in Part II of Schedule E. (These instructions are contained in Notice 88-37 for reporting interest on acquisitions).

J. Debt-Financed Distribution.

The general rule allocates debt in accordance with the owner's use of the proceeds for the owner's share of the interest expense. An optional allocable rule allows a passthrough entity to allocate distributed debt proceeds to either expenditure of the entity that are made during the same taxable year (Reg. § 1.163-8T).

Example

Successful CPA S Corporation is owned equally by Steve and Noelle. Successful CPA borrows $20,000 and distributes all of it to Steve and Noelle. The interest on the money is $2000 for the year. Steve and Noelle each have $1000 in interest and the deductibility of the interest can be based upon what Steve and Noelle did with the funds or allocated to the expenditures of the business. If the interest is allocated to the entity expenditures, it will decrease the income of the entity. If it is allocated to the use of funds by the two shareholders, the deduction will depend on usage of the funds by Steve and Noelle. If Noelle and Steve use the funds for personal purposes the interest will be non-deductible, so allocating the interest to the expenditures of the business makes better planning sense.

> **Note**: The S corporation has a reporting obligation to the shareholders of providing them with a list of all distributions to which debt proceeds were allocated, the amount of those proceeds and the interest expense allocated to such distributions.

III. INVESTMENT INTEREST EXPENSE

Investment interest is deductible to the extend of net investment income, which is the excess of investment income over investment expenses. Any excess may be carried over indefinitely to succeeding tax years.

A. Investment Income.

Investment income is gross income from property held for investment. This generally includes interest, dividends (not qualified dividends, see below), annuities and royalties. It is also gross portfolio income under the passive loan rule and income from trade or business activities in which the taxpayer does not materially participate, if the activities are not treated as passive under the passive loan rule.

In addition, the investment income of a child reported on the parent's return will count as investment income.

Since 1993, § 163(d)(4)(B)(iii) has also allowed electing taxpayers to treat any gain attributable to disposition of property held for investment as investment income. If the taxpayer so elects, the capital gains are not eligible for the maximum capital gains rate of 15% and must be taxed at the taxpayer's regular marginal rate. If the election is not made, net long term capital gain is excluded from investment income.

B. Dividends as Investment Income.

Investment income will include dividend income only to the extent the taxpayer **elects** to treat such income as investment income. Qualified dividend income shall not include any amount which the taxpayer takes into account as investment income under § 163(d)(4)(B)

> **Tax Planning Point**: This election for either long term capital gain or dividend income is desirable if an immediate deduction is sought for investment interest. The ability to deduct the interest immediately usually provides the best tax benefit. If the interest will be deductible the immediately following year the election should be carefully considered.

Example

Genevieve has a $10,000 long term capital gain attributable to investment property that will be taxed at the 35% rate if the election under § 163(d)(4)(B)(iii) is made. However, if she does not make the election, she will have to carry over $10,000 in investment interest which will not be currently deductible. If she includes the capital gain as investment income, then she realizes a 2008 tax benefit of $1,500 ($3,500 in tax savings from the additional $10,000 deduction less $2,000 in additional tax from less of the 15% capital gain rate). If, in 2008, she will have enough regular investment income to cover the suspended interest carryover, she may not want to make the deduction. However, if her income in 2009 is insufficient to allow the deduction, making the election in the current year may be better.

> **Note:** The time value of money is a consideration in planning for the timing of the investment interest expense deduction.

C. How to Make The Election.

The election must be made on or before the due date (including extensions) of the income tax returns for the taxable yare in which the net capital gain is recognized. The election is made on Form 4952, Investment Interest Expense Deduction.

D. Investment Expense.

Note that the investment interest expense deduction is limited to net investment income. That is, investment income minus investment expenses. Investment expense for this calculation is a deductible expense other than interest, directly connected with the production of investment income. These expenses are treated as miscellaneous itemized deductions subject to the 2% of AGI floor and are deductible only to the extent they exceed that floor. For such purposes, miscellaneous itemized deductions other than investment expenses are taken into account first in determining the expenses disallowed by the 2% rule.

Example of Net Investment Income

Katherine's Adjusted Gross Income for 2008 is		$225,000

Investment Income = $10,000

Miscellaneous Itemized Deductions:

Tax Prep	$1,000
Employee Bus. Expense	3,000
Investment Expense	2,900
	$6,900
Less 2% AGI	4,500
Deductible	$2,400

Net Investment Income = $10,000 – 2,400 = $7,600

IV. QUALIFIED RESIDENCE INTEREST

A. Definitions.

Qualified residence interest is interest on debt that is accrued by the taxpayer's principal residence or second residence subject to certain limitations.

A qualified residence is the taxpayer's principal residence (§ 163(h)(4)(A)(i)) or a second residence selected by the taxpayer for the taxable year. The taxpayer must own the home in order for it to qualify. The principal residence would be the home that qualifies for non-recognition of gain under § 121.

A home can include a house, cooperative apartment, condominium, house trailer, or boat, provided it includes basic living accommodations, including sleeping space, toilet and cooking facilities (Temp. Reg. § 1.163-10T(p)(3)(A))

A second residence may be one that is not occupied, occupied part of the year or rented out during the year. If the home is rented out during the year, it may qualify if the taxpayer uses the home the greater of (i) 14 days; or (ii) 10% of the number of days during the year that it is rented at a fair rental value. If the home is not rented out during the year, there is no usage requirement and the home can be considered a second residence.

If the taxpayer has more than one residence that would qualify as a second residence, the taxpayer can select which home will be a qualified second residence. This selection is made each year without regard to the home selected as a second residence in prior years. Generally, a taxpayer cannot elect different residences as the second residence at different times during the same tax year.

B. Limitations on Qualified Residence Interest.

Qualified residence interest includes acquisition indebtedness and home equity indebtedness on a taxpayer's principal and second residence.

C. Acquisition Indebtedness is debt incurred in acquiring, constructing or substantially improving principal or second residence. If a taxpayer refinances the acquisition indebtedness, the new debt is considered acquisition indebtedness to the extent of the old debt immediately before refinancing. Acquisition indebtedness is reduced as payments of principal are made and cannot be increased by refinancing. Aggregate acquisition indebtedness cannot exceed $1,000,000 ($500,000 for married, filing separately).

D. Home Equity Indebtedness is debt other than acquisition indebtedness secured by a qualified residence. Interest on home equity indebtedness is deductible regardless of the use of the proceeds. The aggregate amount of acquisition indebtedness and home equity indebtedness cannot exceed the fair market value of the residences. The aggregate amount of debt treated as home equity indebtedness cannot exceed $100,000 ($50,000 for married, filing separately).

> **AMT Warning**: Home equity indebtedness is not considered qualified housing interest for purpose of the Alternative Minimum Tax and is not deductible for AMT.

> **Caveat**: Home equity debt keeps its status as such only so long as the residence securing the debt remains a qualified residence of the taxpayer. If, for example, the residence is permanently converted to a rental activity, interest on such debt is no longer qualified residence interest not subject to the tracing rules. Instead, the deductibility of interest on such debt is presumably then subject to tracing of the original debt proceeds under § 1.163-8T

As mentioned above, an election can be made to trace home equity indebtedness to use. Taxpayers may elect under Regulation § 1.163-10T(o)(5) to treat debt as if it was not secured by the qualified residence, which entitles them to trace the debt under Reg. § 1.163-8T to its use. This election may be made at anytime with reference to an entire debt. However, once made, it is binding from that point on with reference to that entire debt.

Pitfalls of the Requirement that the Debt be Secured by the Principal Residence or Second Residence:

1. Because may clients have built up equity in their primary residences, it is not unusual for them to borrow against their homes to finance second homes. Although a tempting idea, it can be a planning mistake. One of the requirements of § 163 is that the debt must be secured by the property to be qualified residence interest. Money borrowed from the equity of the primary residence is secured by the primary residence, <u>not</u> the second home. Therefore, unless the debt is for less than $100,000 and can be deducted as home equity interest, the taxpayer does not qualify for the deduction. The loan must be secured by the second home to be qualified residence interest.

2. A similar scenario to #1 is the taxpayer who borrows against investment property (such as an apartment building or commercial property) to finance a principal residence or second home. Although it is perfectly proper to allocate the interest (trace it) to the principal residence or second home under § 1.163-8T, this allocation does <u>not</u> determine deductibility as qualified residence interest under § 163(h)(3).

3. A parent helping a child purchase a first home will often loan money to the child. The interest payments made by the child to their parents will not be deductible unless the loan is secured by the personal residence which requires not only a note but that the note be recorded as a lien in the county in which the house is located. Many parents are reluctant to record such loans, thereby making the interest on such loans non-deductible.

E. Loans Incurred After the Expenditures (Notice 88-74).

If a residence is bought with cash and debt is later incurred, the debt is only acquisition indebtedness if incurred within 90 days of the purchase.

F. Lookback Rules:

Construction loans will constitute acquisition indebtedness to the extent of any construction expenditure made no more than 24 months prior to the date that the debt is incurred.

Debt incurred within 90 days of the completion of construction is deemed to be acquisition indebtedness to the extent of construction expenditures made within 24 months prior to completion date.

A take-out loan used to refinance or payoff a loan on a residential lot on which the taxpayer builds a residence is acquisition debt.

Debt is usually considered to be incurred when the loan proceeds are disbursed (Notice 88-74).

Example #1

George borrows $100,000 to buy a residential lot on January 15, 2005. The debt is secured by the lot. On January 1, 2006 he begins to build his residence on the lot. He spends $350,000 of unborrowed funds to construct the home. It is complete on December 31, 2007 and it becomes his principal residence. On March 15, 2008, George finances the residence for $400,000 and secures the debt to the property. The lender disburses $100,000 to pay off the lot and disburses the remaining $300,000 directly to George.

Results:

$100,000 Loan

From January 15 – December 31, 2005, the interest on the $100,000 is not qualified residence interest because it has not been secured by a qualified residence.

> **Note:** George may want to consider the possibility of deducing the interest as investment interest.

From January 1, 2006 through December 31, 2007, it becomes acquisition indebtedness because a residence under construction is a qualified residence. (§ 1.163-10T(p)(5)).

From December 31, 2007 through March 15, 2008, the debt is acquisition indebtedness because the residence is now a qualified residence.

$300,000 Loan

$100,000 of this debt is treated as debt incurred to construct the residence because it was used to refinance debt incurred to construct the residence.

$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 that 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.

Therefore, all of the interest on this loan is qualified residence interest and deductible.

Example #2

Assume the same facts as in Example #1 except George purchases his lot for cash. In this case, since some of the $400,000 debt was used to refinance a debt incurred to construct the residence only the amount of 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 will count. The expenditures incurred in this time period were $350,000. Accordingly, $350,000 of the debt incurred on March 15, 2008, may be treated as incurred to construct the residence and, 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 $400,000 debt will be deductible as qualified residence interest.

G. Divorce Cases.

Interest paid on a taxpayer's spouse's or former spouse's home, pursuant to a written agreement, is alimony if it meets all the other requirements of § 71.

Interest paid on community debt is deductible 50% as home mortgage interest and 50% as alimony.

A home transferred by one spouse to another in exchange for a mortgage secured by the home creates acquisition indebtedness.

Notice 88-74 states that regulations will 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 § 163 without regard to the transaction under § 1041.

V. TAX RELIEF AND HEALTH CARE ACT OF 2006

A. Mortgage Insurance Deduction

§ 163(h)(3)(E)(i), as amended

B. Background

Lenders require 20% downpayments on the purchase of a home. If the taxpayer has less than a 20% downpayment they can either take out mortgage insurance (covers the lender for risk) or they can take a second loan ("piggyback") to get them to the 20% down. Usually taxpayers choose the latter because the interest on the loan is deductible (even if the interest is somewhat higher than the cost of the mortgage insurance) and the mortgage insurance is not deductible.

For 2007, mortgage insurance become deductible as an itemized deduction. ***The 2007 Tax Increase Prevention Act extended this deduction through the end of 2010***.

C. The Rules.

The deduction is for premiums paid or accrued in connection with acquisition indebtedness of a loan obtained after 01/01/07. The deduction cannot be for refinancing above the acquisition indebtedness (although a proration is possible) but it can be for refinancing existing acquisition indebtedness. Insurance must be paid for periods allocable to 2007 through 2010.

D. Caveat: Prepaid insurance is only deductible if it applies to the current year and if the house is sold prior to the year when insurance was prepaid, the unamortized balance is not deductible.

E. Phaseout

For all taxpayers except MFS the amount that may be deducted is reduced (but not below zero) by 10% for each $1,000 (or fraction thereof) that the taxpayer's AGI exceeds $100,000. No deduction is available if AGI exceeds $109,000. For MFS, the deduction is reduced by 10% of each $500 that the taxpayer's AGI exceeds $50,000.

F. Points

Points or loan original fees are actually prepaid interest and, as such, are ordinarily <u>not</u> deductible under § 461(g)(1), which states that a cash basis taxpayer cannot deduct prepaid interest.

G. § 461(g)(1): Interest that is paid by a cash basis taxpayer that is properly allocable in any period (1) with respect to which the interest represents a charge for the use or forbearance of money, and (2) which is after the close of the taxable year in which the interest is paid, must be capitalized and treated as if it were paid in the period to which it is allocable.

However, there is an exception for certain points. Under § 461(g)(2), § 461(g)(1) does <u>not</u> apply to points paid in connection with indebtedness that is incurred in connection with the purchase or improvement of, and that is secured by, the principal residence of the taxpayer to the extent that, under regulations prescribed by the Secretary, the payment of points is an established business practice in the area in which the indebtedness is incurred and the amount of points paid does not exceed the amount generally charged in that area.

H. Revenue Procedure 94-27

This procedure states that IRS will, as a matter of administrative practice, treat as deductible, any amounts paid by a cash basis taxpayer during the year if all of the following requirements are met:

- <u>Seller-Paid Points</u> – The seller is treated as having paid the amount of the points to the buyer who, in turn, is treated as having used that cash to pay the points charged by the lender. The amount of the seller-paid points is subtracted from the purchase price in computing the basis of the residence.

- The Uniform Settlement Statement (Form HUD-1) must clearly designate the amounts as points payable in connection with the loan.

- The amounts must be computed as a percentage of the stated principal amount of the indebtedness incurred by the taxpayer.

- The amounts paid must conform to an established business practice of charging points for loans for the acquisition of principal residences in the area in which the residence is located and the amount of points paid must not exceed the amount generally charged in that area. If amounts designated as points are paid in lieu of amounts that are ordinarily stated separately on the settlement statement (such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes), those amounts are not deductible as points under Rev. Proc. 94-27.

- The amounts must be paid in connection with the acquisition of the taxpayer's principal residence and the loan must be secured by that residence.

- The amounts must be paid directly by the taxpayer. An amount is so paid if the taxpayer provides from funds that haven't been borrowed for this purpose as part of the overall transaction, an amount at least equal to the amount required to be applied as points at the closing. The amount provided may include down payments, escrow deposits, earnest money applied at the closing and other funds actually paid over by the taxpayer at the closing. In addition, for these purposes, points paid by the seller (including points charged to the seller) in connection with the loan to the taxpayer will be treated as paid directly by the taxpayer from funds that have not been borrowed for this purposes, providing the taxpayer subtracts the amount of any seller-paid points from the purchase price in computing the residence's basis.

Revenue Procedure 94-27 does not apply to points paid in connection with the acquisition of a principal residence to the extent that the points are allocable to an amount of principal in excess of the aggregate amount that may be treated as acquisition indebtedness under § 163(h)(3)(B)(ii).

> **Note:** These points may still be deductible. They just do not fall under the administrative provisions of Rev. Proc. 94-27. The points are deductible if the taxpayer is able to show that the loan proceeds were used for the home improvement or as a part of acquisition of the home.

Points paid in connection with a second house are not deductible as a second home is not the "principal residence."

I. Refinancing

Rev. Proc. 94-27 also does not cover refinancings. However, under § 461(g)(2) points on a refinance will still be deductible if proceeds from the loan are used to improve the personal residence. Otherwise the points are amortized over the life of the loan. If the residence is then refinanced again or sold the unamortized portion may generally be deducted in full at that time.

> **Note:** Case law however, has established that if the lender is the same for both loans the taxpayer must exercise unrestricted control over the funds in order to deduct the unamortized points when the loan is paid off (*J.B. Neble, Jr*. 79 T.C. 751). The taxpayer does not have unrestricted control if the lending institution credits the taxpayer's account with the loan proceeds and then the taxpayer writes a check to the lending institution. More case law indicates that the taxpayer may have unrestricted control if the taxpayer first takes the loan proceeds and commingles them with his or her own funds in an account not maintained with the lender (*N.A. Burgess* 8 T.C. 47).

J. Amortizing Points

If the points aren't deductible under the above rules then they are amortized. Usually economic accrual calculations are required but Rev. Proc. 87-15 simplifies the calculation for individual cash-basis taxpayers. The following requirements must be met:

- The loan is secured by a residence (it need not be the taxpayer's residence);
- The term of the loan is no longer than 30 years; and
- A loan term longer than 10 years must be subject to terms that are customary in the area for loans used to finance the purchase or residential real estate.
- Either:
    - The initial principal amount of the loan must not be greater than $250,000 or
    - The points charged must be limited to four points for a term of loan of 15 years or less, or six points if the term of loan is over 15 years.

Assuming these requirements are met, the following formula is used in calculating the amortization deduction for a taxable year:

<u>Total Points</u>

(# of periodic payments due) * (# of payments made during the year)

Example

Points = $3,000
Length of loan 30 years or 360 months
Payments made in 2007 = 6

Results

$3,000/360 = $8.33 per month
6 months x $8.33 per month = $50.00 deductible 2007

K. Taxpayer Allowed to Amortize Deductible Points – Letter Rul. 199905033

The taxpayers in this ruling bought a house late in the year and incurred points which would normally be deductible under § 461(g)(2). However, the standard deduction was more than the points for that year and so the deduction would be lost UNLESS the taxpayer was allowed to amortize them over the length of the loan. The IRS approved the amortization of the points.

VI. ALTERNATIVE MINIMUM TAX

A. Qualified Housing Interest

For AMT purposes, the term qualified housing interest is substituted for qualified residence interest. Qualified housing interest is interest on a secured debt which is incurred for the purpose of acquiring, constructing, or substantially rehabilitating the taxpayer's residence or a qualified second residence. Qualified housing interest also includes the interest on a debt to refinance a prior debt which qualified. For AMT purposes, interest on home equity debt is not deductible under these rules. However, if the debt proceeds may be traced to investments, the related interest is investment interest for AMT purposes.

B. Investment Interest

As in the calculation of regular taxable income, investment interest is deductible for AMT purposes only to the extent of investment income for AMT purposes. However, because special AMT rules apply to may items of income and deduction, investment interest expense and net investment income for can be very different from those amounts for regular tax. Essentially, a separate Form 4952 (Investment Interest Expense Deduction) must be completed to determine investment interest deductible for AMT purposes. Differences in the numbers on Form 4952 may include:

C. **Investment Interest Expense:**

- Interest on a home equity loan whose proceeds were invested in stock or bonds.
- Carryover of disallowed investment interest expense from a prior year.

D. **Net Investment Income:**

- Private activity bond interest (excludible for regular tax purposes)
- Gain on sale of investment assets (for example, stock acquired via the exercise of an Incentive Stock Option)
- Portfolio management expense over 2% of adjusted gross income

Example

For 2008, I.M.. Investor's investment income and expense are as follows:

Brokerage account money market dividends	$10,000
Tax-exempt interest	15,000
Private activity interest included in above tax-exempt income	3,000
Portfolio management expense deductible for regular tax	1,500
Margin account interest expense	9,000
Home equity loan interest expense – proceeds used to buy stock	3,200

I.M. Investor's deductible investment interest expense for 2008 is:

	Regular Tax	AMT
Net Investment Income:	$10,000	$10,000
Money market dividends	0	3,000
Tax-exempt dividends	- 1,500	- 0
Net Investment Income	8,500	13,000
Investment Interest Expense:		
Margin Account Interest	9,000	9,000
Home Equity Loan Interest	- 0[1]	3,200
Investment Interest Expense	9,000	12,200
Deductible Investment Interest Expense	**$8,500**	**$12,200**

[1] This interest was deducted for regular tax purposes in home equity debt interest (up to loan proceeds of $100,000).

VII. ELECTION TO TREAT DEBT SECURED BY A QUALIFIED RESIDENCE AS NOT SECURED BY THE RESIDENCE

TAXPAYER HEREBY ELECTS, IN ACCORDANCED WITH REG. 1.163-10T(o)(5) TO TREAT FOR THE TAXABLE YEAR AND ALL SUBSEQUENT YEARS THE FOLLOWING DEBT AS NOT SECURED BY A QUALIFIED RESIDENCE.

INSTEAD SUCH DEBT AND ALLOCATION OF INTEREST EXPENSE SHALL BE TREATED IN ACCORDANCE WITH THE TRACING PROVISIONS OF 1.163-8T.

DETAILS OF DEBT:

LENDER:

DESCRIPTION OF PROPERTY:

AMOUNT OF DEBT: