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Turning the Tide on the Mortgage Interest Deduction

My husband wants to buy a boat. Not just any boat, but a vintage mahogany Chris-Craft, preferably from the 1950s or 1960s. I keep catching him late at night surfing the "boats for sale" Internet sites. Whenever he calls me to the computer to show off a particularly lovely model, I counter with a few pesky practical facts (we do not have extra money lying around; we have no boat trailer or storage facility; and our home is situated on a paved cul-de-sac, not a body of water). No matter. He continues to press his case, perhaps hoping my resistance will ease over time.

Buying this type of boat would be an extravagance for our family. We do not need a boat to provide shelter for our family (we have a house) or to provide us with food or income (we never have much luck fishing, and I am allergic to most seafood, anyway). The boat would be a recreational luxury item, used to take weekend boating trips perhaps along the Potomac River or in the Chesapeake Bay.

The federal income tax laws should not offer us a financial incentive to buy a boat. Yet that is precisely what the home mortgage interest deduction provides. Twenty-five years ago, Congress designed § 163(h) of the IRS Code to subsidize second homes, vacation homes, and even boats (in addition to primary residences). These items are the playthings of those who have discretionary income. Few people who worry every week about finding the money to pay the grocery bill have second homes and boats. This column gently pokes fun at my husband's desire for a Chris-Craft in order to raise a more serious point: A tax break that helps people afford luxury items—but wholly unnecessary ones—like vacation homes and houseboats is poor tax policy and should be revised.

Chris-Craft touts itself as America's oldest powerboat builder, listing two U.S. Presidents among its customers over the past 130 years. Several vintage models contain a small galley, complete with a kitchen, beds, and a "head" (the fancy boat name for toilet). A boat with these features qualifies as a residence under the tax code, and the mortgage interest may be deductible under § 163,[1] which is a generous provision. It allows taxpayers to deduct the interest on up to $1,100,000 of mortgage debt. Not only does the interest on the mortgage on a first house qualify, but the interest on the mortgage on a second home also qualifies—whether it is a vacation home in the Rocky Mountains or a vintage boat used for weekend fishing trips.

The mortgage interest deduction was first enacted in 1986. It prohibited the deduction of personal interest while allowing a deduction for "qualified resident interest," defined as interest paid or accrued during the year on debt secured by a qualified residence.[2] A taxpayer could use the mortgage proceeds however he or she wished; however, the indebtedness amount that generated qualified interest was limited. The amount of indebtedness for which an interest deduction was allowable was limited to the lessor of either the fair market value of the residence or the taxpayer's basis plus any debt incurred for certain medical or educational expenses.

While debating the 1986 Tax Reform Act, some members of Congress expressed concern (accurately, it turns out) that the lack of restrictions on the use of the mortgage proceeds created a loophole that allowed taxpayers to get around the prohibition on deducting personal interest.[3] In 1987, Congress changed the definition of "qualified resident interest" to incorporate two newly defined terms: acquisition indebtedness and home equity indebtedness. Congress also changed the debt limitation from a basis and fair market value calculation to a flat $1,000,000 limit on qualified acquisition debt used to acquire, construct, or substantially improve a residence, and a $100,000 limit on home equity debt.

As it now reads, § 163(h) is a wonderful example of why most Americans find the tax code incomprehensible. The relevant subsection employs a double-negative, quadruple-cross-referencing definition. Section 163(h)(1) starts off by stating that no deduction for "personal interest" is allowed under the chapter. Personal interest is defined in the next paragraph by stating what it is not. Personal interest, the code says, is all interest that would be allowable as a deduction *other than* certain categories of interest.[4] Several categories are listed, and the category in subparagraph (h)(2)(D) is "any qualified residence interest." Paragraph (h)(3) then tells us that "qualified residence interest" means interest paid or accrued on acquisition or home equity indebtedness with respect to any qualified residence owned by the taxpayer. Next, both acquisition and home equity indebtedness are defined (providing the third and fourth definitions of the subsection), and limitations of $1,000,000 for acquisition and $100,000 for home equity are established.[5] The definition of acquisition indebtedness requires that the debt be incurred to acquire, construct, or substantially improve a residence. The definition of home equity indebtedness contains no similar restriction.

In the 25 years since 1987, when Congress made these changes, the Internal Revenue Service altered how it read the definitions of acquisition and home equity indebtedness. Historically the IRS has taken the position in litigation that a taxpayer's home equity indebtedness could not be from the same mortgage as a taxpayer's acquisition indebtedness.[6] The IRS won the two court cases in which it advanced this argument, and in June 2001, it reiterated this position in a Field Service Advice Memorandum.[7]

In Letter Ruling 200940030 (Aug. 7, 2009), followed by Rev. Rul. 2010-25 (Oct. 14, 2010), the IRS changed its position on home equity indebtedness, ruling that any mortgage amount that is incurred to acquire, construct, or substantially improve a residence but that exceeds $1,000,000 was by definition not "acquisition indebtedness" under § 163(h)(3)(B). Therefore, up to $100,000 of the mortgage amount over $1,000,000 could qualify as home equity debt, provided that the taxpayer had that much equity in the property.

Even though they were set 25 years ago, these dollar limits remain so high that few Americans will ever reach the mortgage debt ceiling. According to the National Association of Realtors, the average home sales price in 2010 was $220,000 (down from $266,000 in 2007).[8] The most expensive region, the West, had an average home sales price of $264,100 in 2010 (down from $365,900 in 2007). The median home sales price is even lower—$173,000 in 2010.[9] Even if the average homeowner could afford two of these homes, the combined mortgages would still be well below the $1,100,000 deductible debt ceiling provided for in § 163(h).

This holds true in my personal hypothetical case as well. Our existing home acquisition mortgage was about $500,000 (high compared to the national numbers, but average for the Washington, D.C., suburbs). My husband could incur a debt of up to $600,000 to acquire a boat and still have the mortgage interest be deductible (assuming we would qualify for a mortgage that large on top our first home's indebtedness). A $600,000 boat probably would not fit in our driveway; a $200,000 boat seems more realistic. At a 5.5 percent interest rate, in the first year, we would pay about $11,000 in interest on a $200,000 mortgage. When I plug this increased interest deduction into our 2010 tax return software, our itemized deductions increase, our taxable income decreases, and our total tax figure falls by about $3,500.

I usually love seeing my taxes go down (even if just hypothetically), but upon reflection, this hypothetical takes the wind out of my sails. With too many Americans losing their first (and only) homes to foreclosure or struggling to make just one mortgage payment, it is a thoughtless tax policy that would give my family a tax break on a second home (a vintage Chris-Craft second home, nonetheless).

Section 163(h)(2)(D) comes at a high cost to our country. The lost revenue associated with the mortgage interest deduction is estimated at more than $90 billion per year.[10] Contrary to popular belief, this deduction as it is presently designed does little for struggling families hoping to reach the American dream of homeownership. Experts agree that is predominantly the wealthy in our society who benefit from § 163, because taxpayers must itemize their deductions in order to take advantage of the interest deduction.[11] According to the IRS, nearly two out of every three taxpayers claim the standard deduction, rather than itemizing.[12] Just 16 percent of taxpayers in the 10 percent tax bracket itemize, compared with 71 and 89 percent of those in the 33 and 35 percent tax brackets, respectively.[13]

For years, tax and budgetary experts from both political parties have questioned the design, size, and cost of this deduction.[14] Bipartisan consensus can be built around changes, such as changing the deduction to a credit (thereby not requiring a taxpayer to itemize), scaling back the scope of the deduction to $500,000 of mortgage debt, and removing the second home allowance of (h)(4)(i)(II). These few changes would eliminate the offensive parts of § 163 while strengthening its primary goal of helping Americans afford their own home. By listening to the experts and enacting some version of these recommendations, Congress could save $40 billion to $387 billion from 2013 to 2019.[15]

My husband may yet convince me that we need a vintage Chris-Craft, but only if we get to a financial point where I feel that we have extra money lying around. If that time comes, we will not need a tax deduction in order to make the numbers work. I hope that, if we ever find ourselves seriously shopping for a boat, Congress will have excluded interest deductions on second home mortgages and reduced the amount of mortgage debt that qualifies. Twenty-five years is too long for a bad tax policy to exist. It is time for Congress to trim the sails on § 163(h) of the tax code. **TFL**

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Endnotes

[1]26 U.S.C. § 163(h)(2)(D) and (h)(4)(i).

[2]*See* Pub. L. No. 99-514, § 511, 100 Stat. 2085, 2246-47 (repealed 1987).

[3]*See* Joseph A. Snoe, *My Home, My Debt: Remodeling the Home Mortgage Interest Deduction*, 80 Ky. L.J. 431, 482-83 (1992). My husband will be happy to

TAX *continued on page 22*

CYBERIA *continued from page 15*

Not So Good Stuff

Dropbox is nearly perfect, but not perfect. It is, after all, software. Thus, ironically, one needs to install it in order to access the cloud. One must install it on every device in one's inventory.

Potentially more significant for unwitting lawyers is the possibility that privileged documents could be compromised by housing them in the cloud. My earlier column on the cloud addressed this issue in another context and concluded that ethical constraints did not preclude the use of the cloud. With Dropbox or any other such storage system, one should investigate the level of encryption used. One should also check out the company's privacy and use policies. Readers might also want to visit an ominous posting on a site known as Hytechlawyer.com, where, in May 2011, the author warned that a fix to the Dropbox security system had not satisfied him. His story began as follows: "[T]here has been much discussion regarding possible vulnerabilities in Dropbox security that might make the service unsuitable for use by attorneys and others required to protect the confidentiality of data. Reportedly, these issues have been addressed by a software fix. *See* hytechlawyer.com/?p=339. However, for lawyers a more fundamental inquiry is required." The writer's account focused on issues like the possibility that data in the cloud could be given to unauthorized or unintended sources via a subpoena or otherwise. The posting is worth reading.

Finally, even though the mass migration to the cloud now seems to be inexorable, our rush to adopt this convenience should be tempered by lawyerly prudence. There are those who would be delighted to disrupt the Internet on a global scale. Reliance on the Internet always should be tempered by that reality.

Conclusion

Cloud-based computing is upon us. Cyberian lawyers should make this reality work to their maximum benefit but always within the bounds of ethics and prudence. Dropbox and its alternatives should be investigated and, in the right circumstances, may well be a great solution. Meanwhile, see you next month in Cyberia. **TFL**

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TAX *continued from page 17*

know that at least one member of Congress argued the government should not be in the business of telling Americans that buying a sailboat was not a good use of their home equity.

[4]26 U.S.C. § 163(h)(2).

[5]26 U.S.C. § 163(h)(3)(B) and (C).

[6]*See P.S. Pau*, 73 TCM 1819, T.C. Memo. 1997-43, and *P.E. Catalano*, 79 TCM 1632, T.C. Memo. 2000-82.

[7]Field Service Advice Memoranda 200137033 (June 18, 2001).

[8]National Association of Realtors Annual Mean Prices, published at www.realtor.org/research/research/ehsdata.

[9]National Association of Realtors Annual Median Prices, published at www.realtor.org/research/research/ehsdata.

[10]The Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2010–2014, JCS-3-10 (Dec. 15, 2010).

[11]*See* Eric Toder, et al., Reforming the Mortgage Interest Deduction, Urban Institute, at www.urban.org/url.cfm?ID=412099 (April 2010).

[12]Internal Revenue Service, *In 2012, Many Tax Benefits Increase Due to Inflation Adjustments*, IR-2011-104, Oct. 20, 2011.

[13]Benjamin H. Harris and Daniel Baneman, *Who Itemizes Deductions?*, Tax Notes, Jan. 17, 2011, at 345.

[14]Examples abound, but two recent bipartisan efforts are the National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, Dec. 2010 p. 31 *at* www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf and the Bipartisan Policy Center's Debt Reduction Task Force, *Restoring America's Future*, Nov. 2010, pp. 33-34 at www.bipartisanpolicy.org/projects/debt-initiative/about.

[15]Congressional Budget Office, *Budget Options Volume 2*, 187-88 (August 2009).