

THE NEW TAX RULES GOVERNING THE
FINANCING OF OWNER-OCCUPIED HOMES:
THE IMPLICATIONS FOR HOMEBUYERS,
OWNERS, AND LENDERS

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The New Tax Rules Governing the Financing of Owner-Occupied
Homes: The Implications for Homebuyers, Owners, and Lenders

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The tax treatment of owner occupied residential properties has traditionally been one of the major advantages associated with homeownership. Not only was tax compliance easy, but homeownership, in contrast to renting, had always received preferential treatment under the federal income tax. In the last few years, however, a number of important tax changes have occurred that have had a major impact on real estate, both residential and income producing. While residential, owner occupied properties still receive preferential tax treatment, some of the tax benefits of homeownership have been limited. Equally important, the new regulations dealing with homes have become much more complex and will prove more difficult for the average taxpayer to understand and more time consuming and costly to comply with. This, in turn, may make home ownership less attractive. Moreover, unless lenders and real estate agents fully understand these changes, they may find it extremely difficult to effectively advise potential homebuyers.

The purpose of this paper is to acquaint the reader with some of these tax changes and their effects on the costs of homeownership and mortgage financing. We will also look ahead to the possibility of future tax changes and their implications for home financing.

The Tax Reform Act of 1986 (TRA'86) made major changes in the taxation of real estate. Subject to certain transitional rules, Congress eliminated all deductions for personal interest, and greatly reduced the home mortgage interest deduction by limiting the deduction to "qualified residential interest" (QRI).

The Internal Revenue Code (IRC) of 1986 defined qualified residential interest as interest paid or accrued during a taxable year on indebtedness secured by a principal and second residence. Under TRA'86, QRI was deductible to the extent that the debt did not exceed the lesser of (1) the fair market value of the home, or (2) the sum of the adjusted purchase price (cost of the home plus improvements) and debt incurred after August 16, 1986 to pay qualified medical and educational expenses.

Simply stated, this meant that taxpayers could, in general, deduct the interest on home loans on up to two residences so long as the total amount of debt did not exceed the cost of these homes plus improvements and the costs of specified medical and educational expenses. Unfortunately, many taxpayers and financial institutions sought to circumvent the intent of the interest limitation by designing programs that allowed taxpayers to borrow for purposes other than buying a home or purchasing medical and educational services. Consequently, home mortgage interest

rules were significantly changed by the tax legislation of 1987.

The Omnibus Budget Reconciliation Act of 1987 (RA'87), which was designed to reduce the federal budget deficit by raising billions of dollars in tax revenues, defines two types of home mortgage debt for which interest can be deducted. Congress also made some minor changes to the qualified residential interest deduction in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). Now, interest expense on up to \$1 million of acquisition indebtedness (incurred after October 13, 1987) and \$100,000 of home-equity debt is fully deductible as qualified residence interest. The \$1 million and the \$100,000 limitations are the total debt allowed for up to two homes, a principal and second residence, not for individual properties. More specifically, the types of deductible home mortgage interest and the requirements that must be satisfied for this interest to be deductible are described below.

Acquisition Indebtedness

Acquisition Indebtedness can be defined as mortgage debt used to acquire, construct, or improve a qualified residence.

* A residence is any facility that allows for full time habitation. In most cases, this would be any facility that includes sleeping, cooking, and sanitary

accommodations. Thus, this definition can encompass both motor homes and some boats.

- * A qualified residence is a principal residence and up to one secondary residence.
- * A principal residence is the facility that serves as the taxpayer's home for the largest portion of the year.
- * A secondary residence is any dwelling in which the taxpayer resides for more than 14 days (rents out for less than 14 days). If an individual owns more than one second residence, an election must be made each year as to which home to qualify for the home mortgage interest deductions for the entire tax year.

Once the home is purchased, acquisition debt is reduced as principal payments are made and cannot be increased by refinancing except by amounts used to improve the home. For acquisition debt to be deductible, the debt must be secured by the home. However, this requirement can be satisfied after the acquisition debt is procured. For debt to be considered secured, three requirements must be met.

Definition of a Secured Debt

- * The home must be specific security for the debt.
- * In the event of default, the residence must be subject to the satisfaction of the debt with the same priority as a mortgage or a deed of trust.
- * The security instrument must be recorded or otherwise perfected under local law.

So long as the average balance of debts¹ (at year end) on all residences does not exceed the adjusted purchase price of the homes, all of the interest paid on these debts is deductible. This test, which must be performed annually by the taxpayer, is applied separately to each home. If the secured debt is greater than the adjusted purchase price, the Internal Revenue Service regulations provide two methods of calculating deductible qualified residential interest. The taxpayer may choose either method for any year on Form 8598, and, in the case of two residences, different methods may be used. Although most taxpayers who take out mortgages will not have to fill out this form, the IRS estimates that between 10 and 13 million people who have refinanced their homes or obtained second mortgages will have to file the new form.²

A special transition rule applies to home mortgage indebtedness incurred prior to October 14, 1987. This rule provides that the entire amount of home mortgage debt on a qualified residence will be treated as acquisition debt. However, the amount of such debt that is treated as acquisition debt reduces the \$1 million overall limitation applicable to any future acquisition indebtedness. The

1 Internal Revenue Service Temporary Regulation 1.163-10T(h) provides five different methods that can be used by the taxpayer to calculate the average balance of debt.

2 The Wall Street Journal, August 14, 1987 and the Daily Tax Reporter, August 14, 1987.

transition rule does not affect the \$100,000 home equity allowance.

Home Equity Debt

This includes any indebtedness other than acquisition debt secured by a perfected mortgage on a qualified residence, to the extent that the aggregate amount of such debt does not exceed the fair market value of the qualified residence less any acquisition debt to which the residence is already subject. The maximum amount of such debt for which the interest is deductible is limited to \$100,000 (\$50,000 for married couples filing separately). Stated more simply, home equity indebtedness is limited to the amount of net equity in a property up to, but not exceeding \$100,000. The important thing to note about home equity indebtedness is that the proceeds of such debt can be used for any purpose without affecting the deductibility of the interest.

Interest Tracing Rules

In 1987, the IRS issued a set of temporary regulations which are used to classify different types of interest expense. These rules basically attempt to determine the deductibility of interest incurred by identifying how the proceeds of a loan are used. These new regulations can make the determination of what is deductible interest difficult and time consuming to determine, and if not understood by the taxpayer, could result in lost deductions. Fortunately,

special provisions governing home mortgage debt make it unlikely that many home buyers will get into difficulty so long as they have a basic understanding of these new rules and can avoid some of the pitfalls described below.

As far as home financing is concerned, if the lender disburses debt proceeds directly to the seller, the debt is allocated to the property purchased. This is also the case if the purchaser assumes the debt of the seller. In these situations, because it is obvious that the debt proceeds were used to purchase a home, the interest would be deductible, within stated limits, as acquisition indebtedness.

The allocation process becomes much more complicated if the homeowner borrows funds and deposits them directly to a savings or checking account, especially if unborrowed funds are also held in these accounts.

In general, as expenditures are made from the borrower's account, they are deemed to have been made from the borrowed proceeds first. Thus, the debt is allocated to expenditures as they are made and the interest expense is generally characterized on the basis of the purpose of these expenditures.

A borrower may elect to override this provision and can allocate the loan proceeds to any expenditures made from the account within 15 days after the deposit of the borrowed funds. If all of the borrowed funds are not allocated

within 15 days, the remaining debt is allocated to expenditures as they are made.

The 90 Day Rule

The IRS realized that strict adherence to the tracing rules might present some problems in certain home financing situations - where debt was clearly incurred to acquire a home, but the tracing rules would allocate the debt to other expenditures. In order to prevent this from happening, a special 90 day rule was put into effect. According to the IRS Notice 88-74, if expenditures to acquire a residence are made within 90 days before or after the date the debt is incurred, the debt may be treated as incurred to acquire the residence.

Usually, the debt is considered to be incurred on the date the loan proceeds are disbursed. However, according to the notice, the homeowner may treat the debt as being incurred on the date that a written application is made if proceeds are actually disbursed within a reasonable time (within 30 days) after the application is approved. A simple example that may help clarify this rule is provided below.

On June 1, 1988, Bob contracts to purchase a home for \$300,000, with closing scheduled for June 30, 1988. Bob submits a home loan application for \$260,000 on June 5, 1988. Loan approval is delayed. Bob liquidates some of his investments to purchase the home

by the closing date. The loan is approved on July 20th and funds are disbursed on July 31th - a month after the closing. Bob uses the proceeds to replace his investments. If Bob had to follow the tracing rules, the debt would have been allocated to the investment expenditure, and not classified as acquisition debt, which could result in lost interest expense deductions. However, under the 90-day rule, Bob is allowed to treat the loan as being incurred to acquire the home.³

If Bob had delayed his borrowing beyond the 90 day window provided by the regulations, he would not have been able to deduct the mortgage interest on his home loan as acquisition debt. At best, he would only be allowed to deduct interest on the first \$100,000 of this loan as home equity debt.

Home Under Construction

TRA'86 allowed individuals to treat a residence under construction as a qualified residence for a period of up to 24 months, provided the residence becomes a qualified residence when completed. IRS Notice 88-74 indicates that this will continue to be true under the 1987 tax legislation

³ This example was taken from a recent issue of Coopers & Lybrand's Tax Topic Advisory. See "IRS Notice Explains New Limitations On Home Mortgage Interest," Tax Topics Advisory, (August 2, 1988) p.3.

and clarifies this regulation and provides additional rules:

1. The amount of debt that may be treated as acquisition debt is limited to actual expenditures made within 24 months prior to the date is incurred.
2. If the debt is incurred within 90 days after construction is completed, that debt will also qualify to the extent of construction expenditures made during the final 24 months of construction.

Points

As a rule, finance charges or loan fees which represent costs of obtaining the loan - prepaid interest or points - are generally not deducted during the year they are paid, but rather, must be deducted ratably over the life of the debt instrument.

However, there is an exception to this rule for fees paid to lenders at the closing of residential mortgages. Points may be deducted by the purchaser of a principal residence who actually pays the points instead of having them added to the mortgage principal. Note, however, that points cannot be deducted for the purchase of a secondary residence, or in connection with refinancing of a mortgage where the additional proceeds will not be used for the improvement of a principal residence. In such situations, the points must be deducted ratably over the life of the mortgage debt. Even here, however, the deductibility of points that must be spread over the life of the loan will be

limited if the individual is subject to the home mortgage interest limitation. The amount of the points that will be deductible will be limited to the same percentage of interest that is deductible as home mortgage interest as determined on Form 8598. The rest of the points are considered personal interest.

Implications of the New Tax Changes

The new interest tracing rules make a homeowner's initial borrowing decision significantly more important than it was under TRA'86. Individuals should be particularly careful when loan proceeds are deposited into an account with other funds. If the intended expenditure is not made within 15 days (90 days before or after the debt is incurred for a home) after the debt proceeds are deposited into the account, the debt may be allocated to other expenditure categories, for which the interest expense may not be deductible. Although the Service allows a 90 day window for home purchases, if an individual borrows frequently and makes expenditures for investments, business, and personal items, separate accounts for each type of expenditure should be considered. Separate accounts would eliminate the need for tracing the use of borrowed funds.

Given the language of the statute, not all forms of residential financing will qualify as acquisition indebtedness. This would seem to be the case for graduated payment mortgage loans and other types of financing

techniques that involve negative amortization. In the case of graduated payment loans, monthly debt service payments in the early years do not cover all the interest due on the note. This accrued interest is added to the loan balance, increasing the total amount of the loan that must be paid off in the future. As this increase in the loan balance is not used to acquire, construct, or improve a qualified residence, it would not be included as acquisition debt, and, therefore, the associated interest on this incremental debt would only be deductible as home equity debt. If the homeowner had already borrowed up to the limit, none of this additional interest would be deductible.

The new rules also make refinancing much less attractive, especially for homeowners with large equities and low mortgage loan balances. As acquisition debt is now limited to the outstanding balance of the mortgage used to purchase the house, it is no longer possible to convert equity into cash using tax deductible debt. Moreover, points must now be amortized and cannot be deducted the year a property is refinanced, thereby increasing refinancing costs. The new rules on acquisition debt also reduce the benefits of large downpayments.

Future Tax Changes

Continuing concern over the massive federal budget deficit in conjunction with the Gramm-Rudman-Hollings Balanced Budget Act of 1986 which mandates reductions in

spending if specific budget targets are not realized, has increased Congressional interest in finding additional sources of revenue.

The Congressional Budget Act of 1974 requires the Congressional Budget Office (CBO) to submit an annual report to the House and Senate Budget Committees with specific options of reducing the deficit. Some of these revenue options contained in the 1989 report⁴ could have a major impact on the cost of housing if implemented.

A number of options were examined that would further limit the deduction for mortgage interest. One possible option which the CBO estimates could raise an additional \$8 billion in revenues from 1990 to 1994 is capping the mortgage interest deduction at \$12,000 per single tax return or \$20,000 for a joint return (\$10,000 per return for married couples filing separately). Alternatively, the CBO examined limiting the tax savings from the deduction of mortgage interest to 15 percent of interest paid. Aimed at upper income taxpayers, this corresponds to the value of the current interest deduction for taxpayers in the lowest tax bracket. This change is estimated to generate an additional \$49 billion in revenue between 1990 and 1994. The last mortgage interest option is to limit the deduction of

⁴ Congress of the United States, Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options. A Report to the Senate and House Committees on the Budget, Part 11.* U. S. Printing Office (February 1989).

mortgage interest to the acquisition or improvement of only a primary residence plus \$100,000 of other debt secured by this residence. Under this option, interest on a second home would be deductible only to the extent of a \$100,000 of home equity debt. The CBO report estimated that this proposal, which could have far reaching consequences for the second and vacation home markets, would raise about \$1 billion by 1994.

Government revenue estimates indicate that the budget deficit for fiscal 1990, which began in October, should continue to narrow. However, the Gramm-Rudman deficit targets for fiscal 1991 will be much tougher to meet. If additional deficit cutting measures are needed, Congressional interest in some of the revenue options described above may be revived.