nyrej

As a taxpayer, your filing status can limit your mortgage interest deduction

June 25, 2012 - Spotlights

In a recent Tax Court case (Faina Bronstein vs. Commissioner, decision dated May 17, 2012), a taxpayer who filed her 2007 tax return with a filing status of married filing separate had her home mortgage interest deduction limited to the interest on one-half of the $1 million and $100,000 first mortgage and home equity mortgage amounts (i.e., the deduction was limited to the interest paid on $500,000 of home acquisition indebtedness plus the interest paid on $ 50,000 of home equity indebtedness). The court cited the explicit and plain language in Internal Revenue Code to deny the taxpayer the interest expense on the full $1 million of home acquisition indebtedness and $100,000 of home equity indebtedness which is allowed for married filing joint status returns as well as single and head of household status returns.

In 2007, the taxpayer and her father-in-law purchased real property. On the acquisition of the property, they each signed and became liable on a mortgage for $1 million. During 2007, the taxpayer paid all of the mortgage payments due from her own funds. The property was used as the principal residence by the taxpayer and her husband. The father-in-law did not use the property as a principal residence. On her 2007 tax return, approximately $52,000 in home mortgage interest was deducted as an itemized deduction by the taxpayer. The IRS limited her deduction to only $27,000.

The taxpayer and the Internal Revenue Service were in agreement that the mortgage interest met the definition of qualified residence interest because it was paid on home acquisition indebtedness. Acquisition indebtedness is a loan, secured by a primary of secondary residence, for which proceeds are used to construct, improve or acquire a principal or second residence. The security interest must be perfected under local law, for example, by a mortgage or deed of trust document.

The taxpayer's argument to the Tax Court was that Congress could not have intended that an implied marriage penalty would apply to a person in her particular situation. Although she was legally married, the mortgage payments on the residence were all made from her separate funds. In addition, no one other than herself claimed a mortgage interest deduction for the residence. She felt should have been treated as a single individual for the purpose of the deduction.

The Tax Court was unable to deviate from the explicit language provided by the Code. Specifically, Section 163(h)(3)(B)(ii) states, "The aggregate amount treated as acquisition indebtedness for any period shall not exceed $1 million ($500,000 in the case of a married individual filing a separate return);" and Section 163(h)(3)(C)(ii) states, "The amount of home equity indebtedness for any period shall not exceed $100,000 ($50,000 in the case of a separate return by a married individual)." Hence, the taxpayer's deduction was reduced to $27,000, representing the amount of interest paid on $550,000 of mortgage debt. Unfortunately, the taxpayer was also found liable for the 20% accuracy-related penalty. The court regarded the taxpayer as having no substantial authority or reasonable basis on which to base her treatment of the mortgage interest paid.

Sandy Klein, CPA, is a partner at Shanholt Glassman Klein Kramer & Co., New York, N.Y.