PRACTITIONER'S COMMENT

Mortgage Interest, Refinancings and the AMT

by Robert W. Wood, Esq.[*]

There is almost no federal income tax rule more hallowed than the tax deductibility of interest on a home mortgage. Although occasionally the type and nature of tax subsidies for housing has been questioned, virtually no one has suggested eliminating the home mortgage interest deduction. Moreover, the mortgage interest deduction is one of the relatively few federal tax concepts that nearly every lay person understands.

One of the great problems of our tax system, though, is that even things that seem simple often are not simple at all in practice. The deductibility of mortgage interest is replete with limitations on amount and rules governing refinancings, points, and even the interaction between deductions for regular income tax purposes and alternative minimum tax (AMT) purposes. For all of these reasons, approaching a topic that sounds as straightforward as real estate mortgages can be surprisingly detailed.

Although not a great deal has changed in recent years concerning the overall tax treatment of mortgage obligations, the IRS recently attempted to clarify what can be a nettlesome problem. On March 17, 2005, the IRS issued Rev. Rul. 2005-111,[1] in which it clarified issues surrounding qualified housing interest, which is generally deductible for AMT purposes. The IRS determined that qualified housing interest (interest that is deductible for AMT purposes) includes interest paid on a mortgage that has been refinanced more than once, but only to the extent of the balance on the original loan.

If the new mortgage is increased, then the qualified interest deduction is limited to the interest paid on the principal balance that was refinanced. However, the interest attributable to the new amount borrowed will be subject to the AMT. In these days of low interest rates and multiple refinancings, there is added complexity.

The issue that confronted the IRS in Rev. Rul. 2005-11 was whether interest paid on a home mortgage that has been refinanced more than one time is deductible as qualified housing interest for purposes of the AMT. In the revenue ruling, a taxpayer (T) borrowed $100 to purchase a principal residence. Several years later, the outstanding principal balance on the original mortgage was down to $90. T then refinanced the $90 balance through a second mortgage.

After several more years, the outstanding balance on the second mortgage was $80. At that point, T refinanced that $80 balance (his third mortgage), and also borrowed an additional $30. Thus, the total amount on T's third mortgage was $110.

However, T did not use the $30 to acquire, construct, or substantially improve any property that was a principal residence or a qualified residence. On these facts, the IRS ruled that interest paid on a home mortgage that has been refinanced more than one time is deductible as qualified housing interest for purposes of the AMT, as long as the interest on the mortgage that was refinanced is qualified housing interest and the amount of the mortgage indebtedness is not increased.

Thus, the interest paid on T's third mortgage is qualified housing interest, but only to the extent of interest paid on the principal from the original mortgage. In this instance, T borrowed an additional $30 as part of his third mortgage and did not use the $30 to acquire, construct, or substantially improve any property that was a principal residence or a qualified residence. Therefore, T can only deduct the interest paid or incurred on the $80, and not the interest paid on the additional $30.

The IRS reasoned that since the original mortgage was indebtedness incurred in acquiring T's principal residence, the interest paid or accrued on the original mortgage meets the requirements of qualified residence interest under §163(h)(3).

Qualified housing interest is defined for purposes of the AMT as interest that is qualified residence interest and that is paid or accrued during the taxable year on indebtedness that is incurred in acquiring, constructing, or substantially improving any property that is either the taxpayer's principal residence (within the meaning of §121) or one other house, apartment, condominium, or mobile home selected by the taxpayer as his/her qualified residence (provided it is used by the taxpayer as a residence).[2] Qualified residence interest is defined as any interest that is paid or accrued during the taxable year on acquisition indebtedness or home equity indebtedness with respect to any qualified residence of the taxpayer.[3]

Finally, the IRS concluded by stating that the last sentence of §56(e)(1) (defining qualified housing in-

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[1] 2005-14 I.R.B. 816.

[2] §56(e)(1).

[3] §163(h)(3).

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terest for AMT purposes), as clarified by the legislative history, indicates that when §56(b)(1)(C) was enacted as part of the AMT, Congress intended for interest (with respect to a refinancing of a loan that gives rise to qualified housing interest) to be deductible for AMT purposes to the extent that the amount of the loan was not increased. Thus, when T refinanced his original mortgage, the refinanced amount equaled the amount of the outstanding principal. The interest paid or accrued on the second mortgage was deductible as qualified housing interest for purposes of the AMT because the interest on the original mortgage was qualified housing interest, and the amount of the loan was not increased.

This very recent foray into the workings of the deductibility of mortgage interest should make at least one thing eminently clear: the tax rules surrounding the deductibility of interest are among the most detailed rules in the Code. Although the deductibility of interest (and home mortgage interest in particular) may seem straightforward, there are many nuances that must be observed.

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