QUALIFIED RESIDENCE INTEREST DEDUCTION: A WIN FOR UNMARRIED CO-OWNERS

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Despite the seemingly simple language of the statute, the interpretation of the home mortgage interest deduction has recently garnered much attention as the Internal Revenue Service and the courts grappled with its application to unmarried co-owners of a residence. In determining whether the indebtedness limitations apply on a "per-residence" or "per-taxpayer" basis, the Internal Revenue Service, the Tax Court, and the Ninth Circuit have conducted in-depth analysis of the language of the statute, the statute's legislative history, implications of related tax provisions, social and policy concerns, and financial consequences, and have consulted almost every canon of statutory interpretation. This Article examines the legislative history and evolution of the present qualified residence interest deduction and analyzes the differing interpretations of the indebtedness limitations and the ultimate effect of the differing interpretations on taxpayers with different marital status. Also examined is the Internal Revenue Service's surprising announcement that it will follow the Ninth Circuit's holding in Voss v. Commissioner that the indebtedness limitations apply separately to each unmarried co-owner of a residence. This Article concludes with a discussion of possible options for future legislation with regard to the qualified residence interest deduction, repealing or limiting the current deduction or replacing the deduction with a tax credit.

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INTRODUCTION

The marital status of an individual has long been an important consideration in tax planning.[1] Depending on the relative income of individuals, the tax laws may result in a marriage penalty or a marriage bonus. Although in recent years there has been interest in reducing marriage penalty, a decision by the Ninth Circuit Court of Appeals ("Ninth Circuit") has resulted in a substantial marriage penalty in the application of one of the most popular deductions available to individuals. In *Voss v. Commissioner*, the issue was whether the home mortgage interest deduction applies on a per-residence or a per-taxpayer basis.[2] The Ninth Circuit held the indebtedness limitations apply separately to each co-owner of a residence, thereby doubling the indebtedness limitations for unmarried co-owners.[3]

This Article discusses recent developments in the availability of the qualified residence interest deduction, with a focus on the interpretation of the indebtedness limitations. The purpose of the Article is two-fold. First, it intends to be a tool for students, practitioners, and lawmakers desiring to learn more about the complexities of this important tax preference attached to homeownership. Second, it explores the many rules of statutory interpretation and construction used by the Internal Revenue Service ("Service") and the courts in ar-

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1 *See* Rev. Rul. 76-255, 1976-2 C.B. 40 (disregarding "sham" divorces obtained to manipulate, for federal income tax purposes, an individual's marital status as of the close of a tax year).
2 Voss v. Comm'r, 796 F.3d 1051, 1057 (9th Cir. 2015).
3 *Id.* at 1068.

riving at very different results in the application of a seemingly straightforward statute.[4]

Part I explains the evolution of the deduction for interest paid on indebtedness and the historical events that caused taxpayers increased dependency on the ability to deduct interest on personal indebtedness. The Tax Reform Act of 1986 and the Reform Act of 1987 are given special attention: the former establishing the first disallowance of a deduction for personal interest with an exception for home mortgage interest, and the latter greatly transforming the home mortgage interest deduction exception. The congressional intent of both of these tax acts has been critical to the current interpretation of the statute. Part II considers additional issues that must be addressed prior to claiming a home mortgage interest deduction, such as the characterization of a payment as interest, taxable year of the interest deduction, election to itemize deductions, and application to the alternative minimum tax.

Parts III and IV examine recent developments in the interpretation of the indebtedness limitations on the deductibility of qualified residence interest. Part III compares and analyzes the Tax Court's statutory interpretation of the definition of acquisition indebtedness and home equity indebtedness in *Pau v. Commissioner* against the Service's contrary interpretation of those terms in Revenue Ruling 2010-25. Part IV details the very different application of the indebtedness limitations to unmarried co-owners of a qualified residence on a per-residence basis by the Tax Court, in *Sophy v. Commissioner*, and on a per-taxpayer basis by the Ninth Circuit, in *Voss v. Commissioner*. Part V relates the surprising acquiescence by the Internal Revenue Service to the Ninth Circuit's decision in *Voss*, applying the indebtedness limitations on a per-taxpayer basis.

Finally, in Part VI, the focus shifts to the question of whether the statute providing a deduction for qualified residence interest should continue in its current form or be phased out over a period of years. The social policy and economic effects of this tax preference are explored, and the cost in foregone revenue of this tax expenditure is examined. Proposals to repeal or limit the current deduction or convert the current deduction into a more equitable tax credit are also considered.

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[4] The distinction between "statutory interpretation" and "statutory construction" has been stated as follows:

> Although the words "interpretation" and "construction" now appear to be used interchangeably, they are epistemologically different and maintaining the distinction is useful. Interpretation discerns meaning from the words of the statute, possibly as influenced by a variety of extrinsic sources; construction fills a gap and sometimes reads the statute contrary to its words, and is similarly influenced.

JASPER L. CUMMINGS, JR., PRINCIPLES OF APPLICATION OF THE FEDERAL TAX LAWS 18 (2010).

I. HISTORY AND EVOLUTION OF THE QUALIFIED RESIDENCE INTEREST DEDUCTION

The deduction for interest on indebtedness is traceable to one of the original Civil War income tax statutes.[5] A deduction for all forms of interest on indebtedness was also part of the failed Income Tax Act of 1894[6] and, after the passage of the Sixteenth Amendment to the United States Constitution, was part of the Revenue Act of 1913.[7] "When laying the framework for the modern income tax code in 1913, Congress recognized the importance of allowing for the deduction of expenses incurred in the generation of income, which [was] consistent with traditional economic theories of taxable income."[8] As a result, the Revenue Act of 1913 allowed a deduction for all interest paid within the tax year on all types of indebtedness.[9]

The legislative history of the interest deduction is "obscure."[10] Congress gave no explanation for not distinguishing between interest incurred in the personal affairs of the taxpayer and interest incurred in the business and investment activities of the taxpayer.[11] Perhaps, the interest deduction was intended to equalize the tax treatment of taxpayers who must borrow in order to engage in personal, business, or for-profit activities and taxpayers who engage in such activities with their own capital.[12] The breadth of the provision, allowing a deduction for all interest paid, may be based on the administrative difficulty in segregating personal indebtedness from business or investment indebtedness.[13]

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[5] Michael Asimow, *The Interest Deduction*, 24 UCLA L. REV. 749, 749 (1977); *see* Act of Mar. 3, 1865, ch. 78, 13 Stat. 469, 469, 480 (amending Act of June 30, 1864, ch. 173, 13 Stat. 223 (1864)).

[6] Act of Aug. 27, 1894, ch. 349, § 28, 28 Stat. 509, 553 (1895) (addressing deductions). The Supreme Court held the Tax Act of 1894 unconstitutional as the tax on the income from real property was held a direct tax thus violating Article 1, Section 2, clause 3 and Section 9, clause 4 of the Constitution, requiring direct taxes to be apportioned among the several states according to population. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 586 (1895), *vacated by*, 158 U.S. 601 (1895), *superseded by constitutional amendment*, U.S. CONST. amend. XVI.

[7] Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 114, 167 (1915) (addressing deductions allowed).

[8] MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R43385, AN ANALYSIS OF THE GEOGRAPHIC DISTRIBUTION OF MORTGAGE INTEREST DEDUCTION 1 (2014) (citing 50 CONG. REC. 3832 (1913) (statement of Sen. Borah)).

[9] *Id.* at 1–2.

[10] *See* Asimow, *supra* note 5.

[11] *Id.* at 749 nn.2–3; *see* I.R.C. § 262(a) (2012) (disallowing, generally, a deduction "for personal, living, or family expenses"); *see also id.* § 162(a) (allowing, generally, a deduction for "all the ordinary and necessary expenses paid or incurred" in the course of doing business); *id.* § 163(a) (allowing, generally, a deduction for "all interest paid or accrued").

[12] Asimow, *supra* note 5.

[13] *Id.* at 750. The provision's breadth may also be the result of high exemption amounts with the consequence of only a small fraction of individuals being liable for federal income tax in the 1913 tax year. J. MARTIN BURKE & MICHAEL K. FRIEL, TAXATION OF INDIVIDUAL: INCOME 4 (11th ed. 2015).

Arguably, the ability to deduct personal interest endured because of its positive effect on the economy by stimulating credit purchases.[14] The ability to deduct interest on personal debt encouraged credit purchases of consumer goods and provided a strong incentive to purchase, rather than rent, a home.[15]

"The history of federal taxation in the United States mirrors the history of the nation."[16] With the increase in automobile use during the 1920s, the number of home mortgages exceeded the number of farm mortgages.[17] In the 1930s, the mortgage industry was strengthened by the creation of the Federal Housing Administration ("FHA"), which regulated interest rates and the terms of mortgages, and the Federal National Mortgage Association ("Fannie Mae"), which provided local banks with federal money to finance home loans.[18] Home ownership grew rapidly with the return of soldiers after World War II and, by the 1950s, the majority of homeowners had mortgages.[19] As a result of the high tax rates during and after World War II, the impact of the home interest deduction on home purchases became significant.[20] By the 1960s, 62 percent of Americans owned their own home.[21] During the 1970s, individuals began to incur credit card debt, which also generated a deduction for interest paid on any unpaid balance.[22]

A. *Tax Reform Act of 1986*

The Tax Reform Act of 1986[23] has been called "the most far-reaching and fundamental revision of the federal income tax system in its history."[24] The most notable features of the Tax Reform Act of 1986 are the significant broadening of the tax base and the dramatic lowering of the rate structure, for both individual and corporate taxpayers.[25] "The new law has dramatically altered the tax stakes and the planning strategies for virtually every type of taxpayer and

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14 Asimow, *supra* note 5, at 750.

15 *Id.*; *see also* I.R.C. § 164(a)(1) (deduction for real property taxes, providing strong incentives for home ownership); *id.* § 121(a) (exclusion of gain on the sale of a principal residence, also providing strong incentives for home ownership).

16 PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION 20 (6th ed. 2008).

17 Roger Lowenstein, *Tax Break: Who Needs the Mortgage-Interest Deduction?*, N.Y. TIMES MAG., Mar. 5, 2006, at 81.

18 *Id.*

19 *Id.*

20 Steven C. Bourassa & William G. Grigsby, *Income Tax Concessions for Owner-Occupied Housing*, 11 HOUSING POL'Y DEBATE 521, 525 (2000).

21 Lowenstein, *supra* note 17.

22 *Id.*

23 Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

24 JAMES S. EUSTICE ET AL., THE TAX REFORM ACT OF 1986: ANALYSIS AND COMMENTARY ¶ 1.01[1], at 1-5 (1987).

25 *Id.* ¶ 1.01[1], at 1-7.

for every form of economic activity."[26] The Tax Reform Act of 1986 included two major changes to the interest deduction of individual taxpayers: (1) the ability to deduct investment interest was limited to net investment income;[27] and (2) with few exceptions, interest on personal loans became nondeductible.[28]

A major exception to the general disallowance of a deduction for personal interest was qualified home mortgage interest.[29] Taxpayers could continue to deduct personal interest on loans secured by a qualified residence, which included the taxpayer's principal residence and one other residence selected by the taxpayer.[30] Generally, the qualified home mortgage interest deduction was limited to the lesser of the fair market value of the qualified residence or the indebtedness secured by the qualified residence to the extent of the purchase price plus cost of improvements.[31] Interest on any portion of the indebtedness in excess of such amount was not deductible qualified residence interest unless the indebtedness was incurred for qualified educational or medical expenses.[32] If a married couple filed separately, each spouse could take into account only one of the residences, unless both spouses consented in writing to one spouse taking into account both residences.[33] "Qualified residence interest may include interest paid by the taxpayer on debt secured by a residence of the taxpayer that he owns jointly or as a tenant in common, provided that all the requirements for qualified residence interest are met."[34]

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[26] *Id.* ¶ 1.02[4], at 1-21.

[27] Tax Reform Act sec. 511(a), § 163(d)(1) (amending I.R.C. § 163(d)). "Net investment income" is the excess of investment income over investment expenses. I.R.C. § 163(d)(4)(A). "Investment income" is the sum of gross income from property held for investment and net gain attributable to the disposition of such property, to the extent not derived from the conduct of a trade or business. *Id.* § 163(d)(4)(B). Investment interest, which exceeds net investment income, is subject to an unlimited carryover and is deductible in future years, subject to the investment interest limitation. *Id.* § 163(d)(2). Prior to the Tax Reform Act of 1986, a non-corporate taxpayer was permitted to deduct up to $10,000 of investment interest in excess of net investment income. *Id.* § 163(d)(1) (1982) (amended 1986). Congress strengthened the interest limitation to reduce the potential mismeasurement of income from the deduction of investment interest in excess of investment income. JOINT COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 263 (Comm. Print 1987).

[28] Tax Reform Act sec. 511(b), § 163(h)(1) (adding "Disallowance of Deduction for Personal Interest of Individuals" to section 163 of the I.R.C.).

[29] *Id.* sec. 511(b), § 163(h)(2)(D).

[30] *Id.* sec. 511(b), § 163(h)(5)(A)(i).

[31] *Id.* sec. 511(b), § 163(h)(3)(B).

[32] *Id.* sec. 511(b), § 163 (h)(4)(A); *see* I.R.C. § 163(h)(3)(C)(ii) (stating expenditures of the amount borrowed as home equity indebtedness are no longer limited to qualified educational or medical expenditures); *see also* Treas. Reg. § 1.163-10T(c)–(e) (1987) (providing methods and formulas for the allocation of indebtedness if the sum of the average balances for the tax year of all secured indebtedness on a qualified residence exceeds the adjusted purchase price).

[33] Tax Reform Act sec. 511(b), § 163(h)(5)(A)(ii).

[34] JOINT COMM. ON TAXATION, *supra* note 27, at 267.

B. Revenue Act of 1987

The Revenue Act of 1987 dramatically amended the provision allowing the deduction of home mortgage interest.[35]

> The bill amends the definition of qualified residence interest that is treated as deductible. Under the bill, qualified residence interest includes interest on acquisition indebtedness and home equity indebtedness with respect to a principal and a second residence of the taxpayer. The maximum amount of home equity indebtedness is $100,000. The maximum amount of acquisition indebtedness is $1 million.[36]

"Qualified residence interest" includes interest paid on acquisition indebtedness and home equity indebtedness with respect to any qualified residence of the taxpayer.[37] "Acquisition indebtedness" means any indebtedness incurred in the acquisition, construction, or substantial improvement of a qualified residence and refinanced indebtedness not in excess of the balance of the original acquisition indebtedness.[38] "Home equity indebtedness" means any indebtedness, other than acquisition indebtedness, to the extent the amount of the indebtedness does not exceed the fair market value of a qualified residence reduced by the amount of any acquisition indebtedness.[39] As to both acquisition indebtedness and home equity indebtedness, the indebtedness must be secured by the residence.[40] The term "qualified residence" includes the principal residence[41] of the taxpayer and one other residence selected by the taxpayer.[42] Mar-

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[35] *See* Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10102, 101 Stat. 1330, 1330-384 to -386 (amending I.R.C. § 163(h)(3)). With respect to qualified residence interest, the law enacted in the Tax Reform Act of 1986 continued, except as otherwise modified by the Tax Revenue Act of 1987. *See* H.R. REP. NO. 100-391, pt. 2, at 802 (1987), *as reprinted in* 1987 U.S.C.C.A.N. 2313, 2313-420.

[36] H.R. REP. NO. 100-391, at 1032.

[37] I.R.C. § 163(h)(3)(A). *See generally* INTERNAL REVENUE SERV., PUB. NO. 936, HOME MORTGAGE INTEREST DEDUCTION 2 (2015), https://www.irs.gov/pub/irs-pdf/p936.pdf [https://perma.cc/UX86-X8Y3].

[38] I.R.C. § 163(h)(3)(B)(i).

[39] *Id.* § 163(h)(3)(C)(i).

[40] Qualified residence interest is interest on indebtedness "secured by a security interest valid against a subsequent purchaser . . . ." H.R. REP. NO. 100-391, at 1032. Indebtedness will be treated as secured by the taxpayer's residence even though, "under any applicable State or local homestead or other debtor protection law . . . the security interest is ineffective or the enforceability of the security interest is restricted." I.R.C. § 163(h)(4)(C).

[41] The term "principal residence" has the same meaning as provided in Treas. Reg. § 1.121. *See* I.R.C. § 163(h)(3)(C)(i) (exclusion of gain on the sale of a principal residence); *see also* Treas. Reg. § 1.121-1(b)(2) (2002) (stating that the residence the taxpayer uses the majority of the time is ordinarily the taxpayer's principal residence and listing additional factors to consider, including: where the taxpayer is employed, files income tax returns, registers to vote, and registers a car; and where the taxpayer's family, religious organizations, and recreational clubs are located).

[42] I.R.C. § 163(h)(4)(A)(i). To qualify as a second residence, the term "residence" is defined by reference to § 280A(d)(1), which requires the residence to be used by the taxpayer during the tax year for personal purposes for more than the greater of fourteen days or 10 percent of the days the residence is rented, unless it is not rented for any period during the tax year. *Id.*

ried taxpayers filing separately can each claim the interest on only one residence, unless both taxpayers consent in writing that one spouse can claim all of the interest on both residences.[43] The definition of "residence" is broad enough to include a mobile home, boat, and a house trailer that contains a sleeping space, toilet, and cooking facilities.[44]

For each category of qualified residence interest, the Revenue Act of 1987 imposed limitations as to the amount of indebtedness for which the interest is deductible.[45] The maximum amount of acquisition indebtedness is limited to $1 million ($500,000 in the case of married persons filing separate returns),[46] and the maximum amount of home equity indebtedness is limited to $100,000 ($50,000 in the case of married persons filing separate returns).[47] Interest on indebtedness in excess of the monetary limitations is nondeductible personal interest.[48] The Committee Reports on the Revenue Act of 1987 summarized the monetary limitations as follows:

> Thus, under the bill, the total amount of a taxpayer's home equity indebtedness with respect to his principal residence and a second residence, when combined with the amount of his acquisition indebtedness with respect to such residences, may not exceed a $1,100,000 overall limitation ($550,000, in the case of married individuals filing a separate return).[49]

In determining which debt (or portion thereof) exceeds the indebtedness limitations, the Committee Reports state, "until such [Treasury Regulations] are issued, a reasonable method of allocation must be used."[50] If the taxpayer incurred more than one mortgage loan to acquire and improve the residence and the mortgage loans have different interest rates, one possible method of allocation is to pro rate the $1 million ceiling between the first and second mortgages.[51] Another method of allocation is to approach the loan mortgages based on priorities, allowing a deduction for the interest on the first mortgage before al-

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§ 163(h)(4)(A)(i)(II). If a taxpayer has more than one second home, the taxpayer may designate annually the one on which the mortgage interest is deductible. Treas. Reg. § 1.163-10T(p)(3)(iv) (1987) (expounding the original version of Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 511(b), § 163(h)(4)(A)(i)(II), 100 Stat. 2085).

43 I.R.C. § 163(h)(4)(A)(ii).

44 Treas. Reg. § 1.163-10T(p)(3)(ii); *see* BORIS I. BITTKER ET AL., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 22.02[1][b], at 22-6 (3d ed. 2002) ("Thus, interest on a sixty-foot pleasure yacht may be deductible, while interest on a fifteen-foot pleasure fishing boat is nondeductible.").

45 Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10102, 101 Stat. 1330, 1330-384 to -386 (amending I.R.C. § 163(h)(3)).

46 I.R.C. § 163(h)(1)(B)(ii).

47 *Id.* § 163(h)(3)(C)(ii). Expenditures of the amount borrowed as home equity indebtedness are no longer limited to qualified educational or medical expenditures. H.R. REP. NO. 100-391, pt. 2, at 1032 (1987).

48 *See* H.R. REP. NO. 100-391, at 1032.

49 *Id.* at 1033.

50 *Id.*

51 MCDANIEL ET AL., *supra* note 16, at 744.

lowing a deduction for the interest on the second mortgage, up to the $1 million maximum amount.[52] The Committee Reports provided yet another method of allocation, "taking debt into account in the chronological order in which it was incurred or most recently refinanced, with the most recent debt (or portion thereof) treated as the amount of debt that exceeds the limit."[53]

II. Other Relevant Issues Affecting the Deduction of Qualified Residence Interest

Before the question of whether a payment is qualified residence interest can be addressed, an initial determination must be made as to whether the payment is a payment of interest. The Supreme Court defined interest on indebtedness as "compensation for the use or forbearance of money."[54] With regard to mortgage loans, a distinction must be made between charges compensating the lender for the loan and charges compensating the lender for services performed in connection with the loan, for example, appraisal fees, title reports, title insurance, and preparation of loan documents.[55] Regardless of the label, "points" are considered interest for the purposes of Internal Revenue Code ("I.R.C.") section 163 if the points are computed by reference to the amount and terms of the loan[56] and if the points are not withheld from the loan proceeds.[57]

If the payment is a payment of interest, the next question is in which tax year the deduction can be taken. The cash method of accounting is used almost universally by individuals who are wage earners, employees, or other individuals performing personal services, such as doctors and lawyers.[58] The cash method requires income to be reported in the tax year in which the income is

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52 *Id.* at 744–45.
53 H.R. Rep. No. 100-391, at 1033.
54 Deputy v. du Pont, 308 U.S. 488, 498 (1940).
55 Rev. Rul. 69-188, 1969-1 C.B. 54.
56 *See* Rev. Rul. 72-315, 1972-1 C.B. 49. Typically, at the time of closing, home mortgage loans require the payment of prepaid interest in the form of a flat percentage of the loan principal, commonly termed "points." McDaniel et al., *supra* note 16, at 748.
57 *See* Rev. Rul. 69-188, 1969-1 C.B. 54.
58 *See* Bittker et al., *supra* note 44, ¶ 39.01[5], at 39-9. Permissible methods of tax accounting include the cash receipts and disbursements method, and the accrual method. I.R.C. § 446(c)(1)–(2). With exceptions, including qualified personal service corporations, I.R.C. § 448 proscribes the use of the cash method by corporations, partnerships with a corporation as a partner, and tax shelters. *Id.* § 448(a).

> [I]ncome is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. . . . Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account.

Treas. Reg. § 1.446-1(c)(1)(ii)(A) (1960).

actually or constructively received,[59] and deductions to be taken in the tax year in which payment is actually made.[60] Generally, a cash method taxpayer cannot prepay deductible expenses and take a deduction for the prepaid amount in the tax year of payment.[61] The Supreme Court held that such prepayments result in the creation of an asset with a life that extends beyond the tax year of payment and must be allocated to, and deducted in, the years benefited.[62]

I.R.C. section 461(g)(1) specifically defers a deduction for prepaid interest by a cash-method taxpayer,[63] requiring the taxpayer to capitalize and allocate the prepaid interest over the tax years in which the interest represents the cost of borrowed money.[64] Although points are prepaid interest and, as such, deductible over the term of the loan, under I.R.C. section 461(g)(2), points paid to acquire or improve the taxpayer's principal residence may be deducted in the year paid.[65] Assuming the points qualify as deductible interest under I.R.C. section 163(h)(3), the points paid by a cash method taxpayer are deductible in the tax year paid if: (1) the loan is used to buy, build, or improve the taxpayer's principal residence and the loan is secured by the residence; (2) the payment of points is an established business practice in the area where the loan is made; and (3) the points do not exceed the number of points generally charged in that area.[66] However, points paid to refinance a mortgage secured by the taxpayer's principal residence are not deductible in full in the tax year paid and, therefore, must be deducted over the period of the new mortgage loan.[67]

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[59] Treas. Reg. § 1.446-1(c)(1)(i). Although not actually reduced to the taxpayer's possession, constructive receipt occurs in the tax year in which income is either credited to an account, set apart, or otherwise made available to be drawn upon at any time. *Id.* § 1.451-2(a) (as amended in 1979). Although, under I.R.C. § 163(h)(3)(A), "qualified residence interest" includes "interest which is paid or accrued" during the tax year, only interest actually paid during the tax year, and not deferred interest capitalized onto principal, is deductible. *See* Smoker v. Comm'r, 105 T.C.M. (CCH) 1389 (2013).

[60] Treas. Reg. § 1.446-1(c)(1)(i).

[61] *Id.* § 1.461-1(a)(1) (as amended in 1995). The deduction can be taken for the amount of the expenditure allocable to the tax year of the payment. *Id.*

[62] *See generally* INDOPCO, Inc., v. Comm'r, 503 U.S. 79 (1992).

[63] *See* Rev. Proc. 94-27, 1994-1 C.B. 613 (setting forth safe harbor rules for the deductibility of points paid in connection with the acquisition of a principal residence).

[64] I.R.C. § 461(g)(1).

[65] *Id.* § 461(g)(2).

[66] *Id.*; *see* Rev. Proc. 92-12, 1992-1 C.B. 663 (listing the requirements that must be satisfied by a cash method taxpayer for points incurred in connection with the purchase of the taxpayer's principal residence to be fully deductible in the tax year paid) (superseded by Rev. Proc. 94-27, 1994-1 C.B. 613); *see also* Schubel v. Comm'r, 77 T.C. 701, 703–04, 707 (1981) (holding that points withheld from the loan principal disbursement, and not paid separately from the taxpayer's own funds, were not "paid" within the meaning of I.R.C. § 461(g)(2), therefore, not currently deductible).

[67] Rev. Rul. 87-22, 1987-1 C.B. 146. In refinancing the home mortgage, any points paid in respect to any additional indebtedness incurred in connection with the improvement of the taxpayer's principal residence is deductible in the tax year paid. *Id.*

If a payment meets the requirements of qualified residence interest, the interest deduction is an itemized deduction.[68] However, if the standard deduction is larger than the taxpayer's aggregate itemized deductions, the taxpayer will deduct the standard deduction in computing taxable income.[69] In such circumstance, the deduction for home mortgage interest is not reflected in the taxpayer's taxable income. If the taxpayer does elect to itemize deductions, the qualified residence interest deduction is not a "[m]iscellaneous itemized deduction[],"[70] and, therefore, not subject to the 2 percent of adjusted gross income floor under I.R.C. section 67.[71] Nevertheless, qualified residence interest is subject to the overall limitation on itemized deductions under I.R.C. section 68.[72]

Finally, for purposes of the alternative minimum tax ("A.M.T."), the deduction of qualified residence interest is significantly restricted. The interest on a home mortgage is deductible for A.M.T. purposes only if the mortgage is taken out to acquire, construct, or substantially improve a taxpayer's principal residence or a qualified dwelling of the taxpayer.[73] Effectively, interest on second mortgages and home equity loans is not deductible for A.M.T. purposes unless the proceeds are used for substantial home improvements.[74]

III. REVENUE RULING 2010-25

In Revenue Ruling 2010-25, the Service interpreted the definition of "qualified residence interest."[75] The holding maximized a taxpayer's qualified residence interest deduction on the acquisition of a qualified residence.[76] In taking

[68] I.R.C. § 63(d); *see id*. § 62(a) (listing the deductions of an individual allowable in computing adjusted gross income).
[69] *See id*. § 63(b).
[70] *Id*. § 67(b).
[71] *Id*. § 67(a).
[72] *See* I.R.C. § 68(a). Generally, a taxpayer whose adjusted gross income exceeds a threshold amount must reduce the amount of allowable itemized deductions by the lesser of: (1) "3 percent of the excess of adjusted gross income over the [threshold] amount," or (2) eighty percent of the otherwise allowable itemized deductions. *Id*. The three deductions not subject to the overall limitation on itemized deductions are: "(1) [any] deduction[s] under section 213 (relating to medical, etc. expenses), (2) any deduction for investment interest (as defined in section 163(d))," and (3) any deductions under I.R.C. § 165(c)(2), (3) and (d) (relating to casualty, theft, and wagering losses). *Id*. § 68(c).
[73] *Id*. § 56(e)(1). The term "principal residence" is within the meaning of I.R.C. § 121 (exclusion of gain on the sale of a principal residence), and the term qualified dwelling within the meaning of I.R.C. § 163(h)(4) (definition of a qualified residence for the purposes of the home mortgage interest deduction). *Id*. § 56(e)(1)(A)–(B).
[74] *See id*. § 56(e)(1)–(2).
[75] Rev. Rul. 2010-25, 2010-44 I.R.B. 571.
[76] *See id*.

this position, the Service stated it would not follow the Tax Court's decision in *Pau v. Commissioner*.[77]

A. *Pau v. Commissioner*

In *Pau v. Commissioner*, the Tax Court considered whether the $1,000,000 limitation on acquisition indebtedness restricted the amount of the taxpayers' deductible qualified residence interest.[78] In 1989, taxpayers, who were a married couple, purchased a residence in Hillsborough, California, for $1,780,000, with an original mortgage amount of $1,330,000.[79] In 1990, taxpayers claimed a qualified residence interest deduction for interest paid on $1,100,000 of indebtedness.[80] The Service allowed the taxpayers a deduction but limited the amount of the deduction to the interest paid on $1 million of indebtedness.[81] The taxpayers used the residence as their principal residence at all times.[82]

Because the acquisition indebtedness incurred exceeded the $1 million limitation, the Tax Court held the taxpayers could not deduct the interest on the additional $100,000 as home equity indebtedness.[83] The taxpayers failed to demonstrate that the indebtedness in excess of the $1 million limitation was incurred in acquiring, constructing, or substantially improving their residence.[84] The taxpayers also failed to demonstrate that any part of the $100,000 excess indebtedness was home equity indebtedness.[85] In support of the holding, the Tax Court quoted I.R.C. section 163(h)(3)(C)(i), "home equity indebtedness is defined as 'any indebtedness (*other than acquisition indebtedness*) secured by a qualified residence.' "[86]

B. *Chief Counsel Advice 200940030*

The Service, in Chief Counsel Advice ("C.C.A.") 200940030, addressed the issue of whether indebtedness incurred to acquire a qualified residence in excess of $1 million limitation could constitute home equity indebtedness.[87] In

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77 *Id*. The Service also stated that it would not follow the decision of *Catalano v. Commissioner*. *See* Catalano v. Comm'r, 79 T.C.M. (CCH) 1632, 1636 (2000) (following the *Pau* decision that the amount of deductible residence mortgage interest was restricted to the interest paid on $1 million of acquisition indebtedness), *rev'd*, 279 F.3d 682 (9th Cir. 2002).
78 Pau v. Comm'r, 73 T.C.M. (CCH) 1819, 1819 (1997).
79 *Id*. at 1819, 1823.
80 *Id*. at 1823.
81 *Id*.
82 *Id*.
83 *Id*. at 1826.
84 *Id*.
85 *Id*.
86 *Id*. (emphasis in original).
87 Memorandum No. 200940030 from Christopher F. Kane, Branch Chief of Income Tax & Accounting, Internal Revenue Serv. Office of Chief Counsel, to Samuel Berman, Special

addressing this question, C.C.A. 200940030 considered a taxpayer who purchased a principal residence for $1.5 million; the taxpayer paid $200,000 cash and borrowed the remaining $1.3 million through a loan secured by the residence.[88]

The Service noted that the definition of home equity indebtedness is indebtedness, other than acquisition indebtedness, secured by the residence subject to fair market value and $100,000 limitations.[89] As stated by the Service, "the resolution of the issue depends on the definition of 'acquisition indebtedness,'"[90] which has two possible interpretations.[91] "Under the first interpretation, *acquisition indebtedness means all indebtedness*, regardless of amount, incurred to acquire, construct, or substantially improve a qualified residence."[92] Under this interpretation, the $1 million indebtedness limitation is not an element of the definition but a separate limit on deductibility, and, as such, any indebtedness in excess of $1 million remains acquisition indebtedness.[93]

Under the second interpretation, *the $1 million indebtedness limitation is part of the definition of acquisition indebtedness*.[94] Under this interpretation, a taxpayer who borrows in excess of $1 million to acquire, construct, or substantially improve the residence may deduct the excess as home equity indebtedness because the excess is not acquisition indebtedness.[95] As a result, the taxpayer can deduct the interest on a total of $1.1 million of qualified residence interest incurred in the acquisition, construction, and improvement of a qualified residence, assuming compliance with the other requirements of I.R.C. section 163(h)(3)(B) and (C).[96] The Service concluded that the second interpretation was the better statutory interpretation of the terms "acquisition indebtedness" and "home equity indebtedness."[97]

In addition, the Service found that the second interpretation best comports with how the term "acquisition indebtedness" is used in other sections of the Internal Revenue Code;[98] I.R.C. section 163(h)(3)(A), which defines "qualified residence interest," would be rendered meaningless if the $1 million and $100,000 limitations are not included in the definition of acquisition indebtedness and home equity indebtedness.[99] I.R.C. section 108(h)(2) provides for ex-

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Counsel of Small Business/Self-Employed, Internal Revenue Serv. (Aug. 7, 2009) [hereinafter C.C.A. 200940030].

[88] *Id*. at 2.

[89] *Id*. at 2–3.

[90] *Id*. at 2.

[91] *Id*. at 3.

[92] *Id*. (emphasis added).

[93] *Id*.

[94] *Id*.

[95] *Id*.

[96] *See id*. at 2–3.

[97] *Id*. at 3.

[98] *Id*.

[99] *Id*.

clusion of cancellation of indebtedness income on the discharge of qualified principal residence indebtedness.[100] This provision adopts, as the definition of "qualified principal residence indebtedness," the definition of acquisition indebtedness, citing I.R.C. section 163(h)(3)(B), with the substitution of a $2 million indebtedness limitation.[101] The increase in limitation amount is necessary only if the definition of the term acquisition indebtedness includes the $1 million indebtedness limitation.[102] Finally, for the purposes of A.M.T. under I.R.C. section 56(e), "qualified housing interest" is defined, in part, as qualified residence interest under I.R.C. section 163(h)(3) paid during the tax year on indebtedness incurred in acquiring, constructing, or substantially improving the principal residence or a qualified dwelling of the taxpayer.[103] Clearly, the congressional intent was not to allow a deduction for A.M.T. purposes without a limitation.[104]

C. *Revenue Ruling 2010-25*

In Revenue Ruling 2010-25, the Service ruled that indebtedness incurred by a taxpayer in acquiring, constructing, or substantially improving a qualified residence could constitute home equity indebtedness to the extent the indebtedness exceeded $1 million, subject to the $100,000 and fair market value limitations.[105] In 2009, an unmarried taxpayer purchased a principal residence for $1.5 million, paying $300,000 and financing the remainder of the purchase price through a loan secured by the residence.[106] Without reference to C.C.A. 200940030, the Service held that the taxpayer could deduct interest paid on an aggregate indebtedness of $1.1 million as qualified residence interest:

> Under § 163(h)(3)(A), the interest on both acquisition indebtedness and home equity indebtedness is qualified residence interest. Therefore, for 2009 Taxpayer may deduct interest paid on indebtedness of $1,100,000 as qualified residence interest. Any interest Taxpayer paid on the remaining indebtedness of $100,000 is nondeductible personal interest under § 163(h).[107]

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100 *Id.*; *see* I.R.C. § 108(a)(1)(E) (2012).
101 C.C.A. 200940030, *supra* note 87, at 4; *see* I.R.C. § 108(h)(2).
102 C.C.A. 200940030, *supra* note 87, at 4. The discharge of qualified principal residence indebtedness was excluded from gross income under I.R.C. § 108(a)(1)(E), and was extended through December 31, 2016. Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, § 151(a), 129 Stat. 2242, 3065 (2015).
103 C.C.A. 200940030, *supra* note 87, at 4.
104 *See id.* at 5.
105 Rev. Rul. 2010-25, 2010-44 I.R.B. 571.
106 *Id.*
107 *Id.*

IV. QUALIFIED RESIDENCE INTEREST AND UNMARRIED CO-OWNERS

Whether same sex or opposite sex, unmarried couples often take joint title to dwelling units used as a principal resident or as a second residence.[108] Individuals, who are not a couple, also may co-own dwelling units used as a principal residence or as a second residence.[109] For example, second homes located in recreational areas may be owned by several families or residences located in areas of the country with high property values may be owned by multiple families.[110] Whatever the circumstance, whether the statutory limits on acquisition indebtedness and home equity indebtedness apply to unmarried co-owners on a per-residence basis or a per-taxpayer basis makes a significant difference in the taxpayer's ultimate tax liability.[111]

Recently, the Service and the courts have provided conflicting interpretations of the indebtedness limitations included in the definitions of "acquisition indebtedness" and "home equity indebtedness."[112] Acquisition indebtedness is defined by statute as any indebtedness that is incurred in (or indebtedness resulting from the refinancing of indebtedness incurred in) acquiring, constructing, or substantially improving a qualified residence and is secured by the residence.[113] *Acquisition indebtedness is limited to an aggregate amount of indebtedness not to exceed $1 million ($500,000 in the case of a married person filing a separate return)*.[114] Home equity indebtedness is defined by statute as any indebtedness (other than acquisition indebtedness) to the extent that the fair market value of a qualified residence exceeds the amount of the acquisition indebtedness on the residence.[115] *Home equity indebtedness is limited to an aggregate amount of indebtedness not to exceed $100,000 ($50,000 in the case of a married person filing a separate return)*.[116]

A. *The Marriage Bonus and the Marriage Penalty*

Marriage often affects tax liability of a couple, resulting in a *marriage penalty* (an increase in tax liability) or a *marriage bonus* (a decrease in tax liability). In fact, a marriage penalty was embedded in the Revenue Act of 1913, which allowed a personal exemption of $3,000 for a single individual and $4,000 for married individuals.[117] In 1948, a significant marriage bonus was

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108 Brief for Professor Patricia Cain et al. as Amici Curiae Supporting Appellants, at 10, Voss v. Comm'r, 796 F.3d 1051 (9th Cir. 2015) (Nos. 12-73257, 12-73261).

109 *Id.*

110 *Id.*

111 *See generally id.* at 10–13.

112 *See supra* Part III.

113 I.R.C. § 163(h)(3)(B)(i) (2012).

114 *Id.* § 163(h)(3)(B)(ii).

115 *Id.* § 163(h)(3)(C)(i).

116 *Id.* § 163(h)(3)(C)(ii).

117 Robert S. McIntyre & Michael J. McIntyre, *Fixing the "Marriage Penalty" Problem*, 33 VAL. U. L. REV. 907, 908 n.4 (1999). Single taxpayers with income greater than $3,000 and

created by the adoption of a separate rate schedule for married couples filing a joint return.[118] The joint return is a form of income splitting enacted to alleviate the tax disparity between community property states and common law states.[119] Often, joint filing results in a marriage bonus, which is greatest if one spouse is the sole or primary income earner.[120] In response to criticism of the marriage bonus created by the joint return, in 1951, Congress enacted a special rate schedule for heads of household and, in 1954, allowed surviving spouses to use the joint return rates for two years following the deceased spouse's death.[121] Due to continuing complaints, in 1969, Congress enacted a new rate schedule for unmarried individuals, which created a marriage penalty for married individuals who earn relatively equal amounts of income.[122]

Even though one of the spouses has neither income or deductions, married individuals may file a single return jointly if the following requirements are met:

> (1) they are married at the close of the taxable year or, if one dies before the close of the table year, at the time of the decedent's death; (2) neither spouse is a nonresident alien at any time during the taxable year; and (3) husband and wife have the same taxable year, with an exception for different table years resulting from death.[123]

If a joint return is filed, the income and deductions of the couple are computed on an aggregate basis, with each spouse being jointly and severally liable for any taxes due.[124] If married individuals file separate returns, each spouse re-

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married taxpayers with income greater than $4,000 were subject to a 1 percent tax rate. Act of Oct. 3, 1913, ch. 16, §§ II(A)(1), II(C), 38 Stat. 114, 166, 168. High-income taxpayers were subject to an additional tax that resulted in progressive, combined rates of 1 percent to 6 percent. *Id.* § II(A)(2). The $3,000 and $4,000 exemption amounts adjust for inflation; this is equivalent to $66,100 and $88,100, respectively, in 2010. *See generally* CONG. BUDGET OFFICE, FOR BETTER OR FOR WORSE: MARRIAGE AND THE FEDERAL INCOME TAX (1997) (examining the ways in which federal tax law affects the income taxes that married couples pay and how demographic and labor market changes have altered those effects).

118 Ellen D. Cook, *No Simple Solution for the Marriage Penalty Quandary*, 64 PRAC. TAX STRATEGIES 160, 161 (2000).

119 BITTKER ET AL., *supra* note 44, ¶ 44.02[2], at 44-19. Generally, income is taxed to the earner thereof, and the basic principal of the community property system is that each spouse has a present interest in one half of the couple's income from personal services or from community property; therefore, one half of the couple's community income for the tax year is taxable to each spouse. *See* Poe v. Seaborn, 282 U.S. 101, 116–17 (1930) (citing Lucas v. Earl, 281 U.S. 111 (1930)).

120 BITTKER ET AL., *supra* note 44, ¶ 44.02[5], at 44-28.

121 *Id.*

122 *See id.* ¶ 44.02[5], at 44-28 to -29 (discussing additional legislation enacted by Congress to alleviate the marriage penalty). *See generally* MCDANIEL ET AL., *supra* note 16, at 1310 (discussing competing and conflicting policy objectives in the choice of taxable units).

123 I.R.C. § 6013(a) (2012); BITTKER ET AL., *supra* note 44, ¶ 44.02[2][a], at 44-21.

124 *See* I.R.C. § 6013(d)(3).

ports the income and deductions generated by that spouse.[125] The determination of whether an individual is married is made as of the close of the individual's tax year.[126]

In recent years, considerable interest has been directed at alleviating or eliminating the marriage penalty.[127] However, any legislative reform aimed at relieving the marriage penalty in order to benefit two-earner couples have been attacked as unfair to one-earner couples, unmarried taxpayers, or both.[128] Effective as of 2012, the marriage penalty was removed from the 10 and 15 percent tax brackets and the standard deduction.[129] Nevertheless, the marriage penalty is still embedded in the other tax brackets, and in the many threshold and phase out amounts found throughout the I.R.C.[130] A recent example of the continuance of the marriage penalty is I.R.C. section 1411, which imposes a 3.8 percent tax on net investment income,[131] allows an untaxed threshold amount of $250,000 for joint filers, and $200,000 for all other filers.[132] Other sections of the I.R.C. that contain a marriage penalty include, but are not limited to: I.R.C. section 1(h) (20 percent capital gains rate on high-income taxpayers); I.R.C. section 24 (child care credit); I.R.C. section 32 (earned income credit); I.R.C. section 68 (overall limitation on itemized deductions); I.R.C. section 86 (taxation of social security benefits); I.R.C. 151 (deduction for personal exemptions); and I.R.C. section 1211 (deduction of net capital losses).[133]

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125 BITTKER ET AL., *supra* note 44, ¶ 44.02[2][c], at 44-24.

126 I.R.C. § 7703(a)(1). If the individual's spouse dies during the tax year, the determination of whether an individual is married is made on the date of the spouse's death. *Id.* Individuals legally separated from their spouse under a decree of divorce or legal separation are not considered married for federal income tax purposes. *Id.* § 7703(a)(2). If the taxpayer's spouse is not a member of the household during the last six months of the tax year, a married taxpayer filing a separate return is treated as unmarried for the purposes of determining the taxpayer's entitlement to personal exemptions and head of household status. *Id.* § 7703(b)(3). *See generally* United States v. Windsor, 133 S. Ct. 2675 (2013) (holding that Section 3 of the Defense of Marriage Act, Pub. L. No. 104-199, 110 Stat. 21419 (1996), limiting the meaning of the words "marriage" to a legal union between one man and one woman and "spouse" to a person of the opposite sex, is an unconstitutional denial of equal protection in violation of the Due Process Clause of the Fifth Amendment); Rev. Rul. 2013-17, 2013-38 I.R.B. 201 (holding, for federal tax purposes, the marital status of an individual of the same sex who is lawfully married under the law of the state that recognizes such marriages will be recognized).

127 BITTKER ET AL., *supra* note 44, ¶ 44.02[5], at 44-30.

128 *Id.*

129 *See id.* ¶ 44.02[5], at S44-16 (Supp. II 2016).

130 *See* Cook, *supra* note 118, at 165–66.

131 Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1411(a)(1)(A), 124 Stat. 1029, 1061 (codified as amended at I.R.C. § 1411(a)(1)(A) (2012)).

132 I.R.C. § 1411(b). The 3.8 percent tax is imposed on the lesser of: (1) net investment income for the tax year; or (2) the taxpayer's modified adjusted gross income for the tax year over the threshold amount. *Id.* § 1411(a)(1)(A)–(B).

133 I.R.C. §§ 1(h), 24, 32, 68, 86, 151, 1211.

B. Chief Counsel Advice 200911007

In C.C.A. 200911007, the Service addressed the issue of how to apply the $1 million limitation on acquisition indebtedness where the taxpayer is a partial owner of the residence for which the total acquisition indebtedness exceeds $1 million.[134] The taxpayer financed the acquisition of a residence by obtaining a loan in excess of $1 million, secured by the residence.[135] The next year, the taxpayer transferred the residence to himself and a co-owner as joint tenants, who was added as an additional obligor on the mortgage.[136] Both the taxpayer and the co-owner used the residence as their principal residence.[137] For the first two tax years at issue, the taxpayer paid all of the interest due on the mortgage and, during the third tax year, the taxpayer and the co-owner each paid a percentage of the interest due on the mortgage.[138] For the third tax year, the taxpayer argued that the $1 million indebtedness limitation on acquisition indebtedness should be interpreted to allow a $1 million limitation for each the taxpayer and the co-owner.[139]

In response, the Service stated that the plain language of the statute did not support this interpretation.[140] Under I.R.C. section 163(h)(3)(B)(i), "acquisition indebtedness is defined [] as indebtedness incurred in acquiring a qualified residence of the taxpayer—not as indebtedness incurred in acquiring taxpayer's *portion* of a qualified residence."[141] "The entire amount of indebtedness incurred in acquiring the qualified residence constitutes acquisition indebtedness under I.R.C. section 163(h)(3)(A)(i). . . . However, under I.R.C. section 163(h)(3)(B)(ii), the amount *treated* as acquisition indebtedness for purposes of the qualified residence interest deduction is limited to $1,000,000. . ."[142] In support, the Service noted the parenthetical language in I.R.C. section 163(h)(3)(B)(ii), which limits the amount treated as acquisition indebtedness to $500,000 for a married taxpayer filing a separate return.[143]

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134 Memorandum No. 200911007 from John P. Moriarty, Chief of Income Tax & Accounting Branch 1, Internal Revenue Serv. Office of Chief Counsel, to Catherine G. Chang, Att'y, San Francisco, Internal Revenue Serv., at 2 (Nov. 24, 2008) hereinafter C.C.A. 200911007].
135 *Id.*
136 *Id.*
137 *Id.*
138 *Id.*
139 *Id.* at 4.
140 *Id.*
141 *Id.* (emphasis in original).
142 *Id.* As the legal and equitable owner of the property, the taxpayer was entitled to deduct the interest actually paid on the mortgage. *Id.* at 3. If the average balance of the indebtedness exceeds the indebtedness limitation, the amount of deductible qualified residence interest with respect to the indebtedness is determined by multiplying the interest paid with respect to the debt by a fraction, the numerator of which is the applicable indebtedness limitation and the denominator of which is the average balance of the indebtedness. *Id.* at 4 (citing Treas. Reg. § 1.163-10T(e) (1987)).
143 *Id.* at 4.

The Service concluded that the \$1 million indebtedness limitation is used to determine the *portion* of the qualified residence interest that the taxpayer may be deducted.[144] The formula for determining the amount of qualified residence interest deductible by the taxpayer is as follows: multiply the amount of interest actually paid by the taxpayer by a fraction, the numerator of which is \$1 million and the denominator of which is the average balance of the outstanding acquisition indebtedness in the tax year at issue.[145]

C. *Sophy v. Commissioner*

In *Sophy v. Commissioner*, the Tax Court considered the question of whether the statutory limitations on acquisition indebtedness and home equity indebtedness should be applied to unmarried co-owners on a per-residence or per-taxpayer basis.[146] Charles J. Sophy and Bruce H. Voss were domestic partners registered with the State of California.[147] Between 2000 and 2002, the taxpayers purchased residences in Rancho Mirage, California, and Beverly Hills, California.[148] Both residences were financed and refinanced with indebtedness secured by the residences for which the taxpayers were jointly and severally liable.[149] The taxpayers took title to the residences as joint tenants.[150] During the tax years at issue, the taxpayers used the Beverly Hills residence as their principal residence and the Rancho Mirage residence as their second residence.[151] In 2006 and 2007, the total average balance for the home mortgages and home equity lines of credit was \$2,703,568 and \$2,669,136, respectively.[152]

For tax years 2006 and 2007, the taxpayers each filed separate federal income tax returns and each claimed a home mortgage interest deduction under I.R.C. section 163(h)(3).[153] Their sole contention was that the \$1 million and \$100,000 indebtedness limitations apply to a residence co-owned by unmarried individuals on a per-taxpayer basis.[154] The Service's position was that the indebtedness limitations apply on a per-residence basis, regardless of the number

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[144] *Id.* at 2.
[145] *Id.* at 4 (citing Treas. Reg. § 1.163-10T(e) (1987)).
[146] Sophy v. Comm'r, 138 T.C. 204, 209 (2012), *rev'd*, Voss v. Comm'r, 796 F.3d 1051 (9th Cir. 2015).
[147] *Voss*, 796 F.3d at 1055. "Domestic partners are two adults who have chosen to share one another's lives in an intimate and committed relationship of mutual caring." CAL. FAM. CODE § 297(a) (2012); *see also id.* §§ 297–299.6 (providing the rules applicable to domestic partners and domestic partnerships).
[148] *Sophy*, 138 T.C. at 205.
[149] *Id.* at 205–06.
[150] *Id.* at 205.
[151] *Id.* at 206.
[152] *Id.*
[153] *Id.* at 206–07.
[154] *Id.* at 209; *see supra* Part III (discussing the Service's position in C.C.A. 200940030 and Revenue Ruling 2010-25, which allows for the aggregation of the indebtedness limitations upon the acquisition, construction, or substantial improvement of a qualified residence).

of owners and whether or not the co-owners are married to each other.[155] Following the reasoning of C.C.A. 200911007,[156] the co-owners were collectively limited to a deduction for qualified mortgage interest paid on a maximum of \$1.1 million of acquisition and home equity indebtedness.[157] The Service computed the limitation ratio as \$1.1 million over the average balance of the qualifying loans.[158] The limitation ratio was then multiplied by the amount of qualified mortgage interest paid by each taxpayer during the tax year to arrive at the amount of deductible interest.[159] Each taxpayer filed a petition with the Tax Court, and the two cases were consolidated.[160]

In *Sophy*, after reviewing the language of the statute and the legislative intent, the Tax Court concluded that the indebtedness limitations are properly applied on a per-residence basis.[161] The analysis began with a close examination of the definitions of "acquisition indebtedness" and "home equity indebtedness," noting that the word "taxpayer" is not used in relation to either type of indebtedness.[162] Further, in defining "qualified residence interest," the terms "acquisition indebtedness" and "home equity indebtedness" focus on the individual taxpayer only with regard to the qualified residence and not to the indebtedness.[163] Congress's use of the phrase "any indebtedness" without the phrase being qualified by language referring to an individual taxpayer led to the conclusion by the Tax Court that the focus of the statutory limitations is the amount of indebtedness with respect to the residence rather than the amount of indebtedness with respect to the individual taxpayer.[164]

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155 *Sophy*, 138 T.C. at 209; *see also* Bronstein v. Comm'r, 138 T.C. 382, 382–83 (2012) (holding that a married woman, filing separately, with title to her principal residence held in her name and the name of her father-in-law, was limited to qualified residence interest on \$550,000 of acquisition indebtedness and home equity indebtedness).

156 *Sophy*, 138 T.C. at 206–07; *see also supra* Part IV B (discussing the Service's position in C.C.A. 200911007 that the acquisition indebtedness limitation applies on a per-residence basis).

157 *Sophy*, 138 T.C. at 209.

158 *Id.* at 207.

159 *Id.*

160 *Id.* at 204–05.

161 *Id.* at 213. In interpreting the statute, the Tax Court began by stating that its purpose was to give effect to Congress's intent, and that the statutory language was the most persuasive evidence of statutory purpose. *Id.* at 209. The Tax Court then listed several rules of statutory interpretation: (1) "the words of the statute should be construed in their ordinary, everyday, and plain meaning;" (2) "usually the meaning of the statutory language is conclusive;" (3) if a statute is silent or ambiguous, the statute's legislative history may be considered in an attempt to determine congressional intent; and (4) if a statute appears clear on its face, unequivocal evidence of legislative purpose is necessary before interpreting the statute contrary to its plain meaning. *Id.* at 209–10.

162 *Id.* at 210.

163 *Id.* The home equity indebtedness is also "reduced by the amount of acquisition indebtedness with respect to such residence." *Id.* (emphasis omitted).

164 *Id.* at 210–11.

The Tax Court relied on several rules of statutory construction to further dispel the taxpayer's per-taxpayer interpretation of the statue. First, if Congress uses language in one section of a statute but not another section of the same statute, the presumption is that the omission by Congress is intentional and purposeful.[165] Although Congress refers to the "taxpayer" several times in I.R.C. section 163(h), no reference to an individual taxpayer is made in the indebtedness limitation language.[166] Second, a statute should be construed to prevent a clause, sentence, or word from being superfluous, void, or insignificant.[167] Congress's repeated use of phrases such as "with respect to any qualified residence" and "with respect to such residence" in conjunction with terms, which, by their own definitions, already relate to a qualified residence, would be superfluous if the indebtedness limitations were applied on a per-taxpayer basis.[168] Third, a statute must be construed not in isolation but as part of a statutory scheme.[169] With I.R.C. section 163(h)(3) taken as a whole, Congress's repeated references to such phrases "emphasize the point that qualified residence interest and the related indebtedness limitations are residence focused rather than taxpayer focused."[170]

Finally, the Tax Court found support for applying the indebtedness limitations on a per-residence basis in the parenthetical language addressing married persons filing separate returns.[171] In the case of a married individual filing a separate return, the parenthetical language limits acquisition indebtedness to $500,000 and home equity indebtedness to $50,000.[172] This language suggests, "without expressly stating, that co-owners who are married to each other and file a joint return are limited to a deduction of interest on $1 million of acquisition indebtedness and $100,000 of home equity indebtedness."[173] The Tax Court found unpersuasive the taxpayers' argument that this parenthetical language, which creates a marriage penalty, does not apply to unmarried co-owners in light of the residence-focused language of I.R.C. section 163(h)(3) and the absence of any reference to an individual taxpayer in the indebtedness limitations.[174] Rather than establishing a marriage penalty, the Tax Court reasoned the parenthetical language merely implies that unmarried co-owners may allocate the indebtedness limitation amounts in a different manner, such as according to percentage of ownership.[175]

[165] *Id*. at 211.
[166] *Id*.
[167] *Id*.
[168] *Id*.
[169] *Id*. at 211–12.
[170] *Id*. at 212.
[171] *Id*.
[172] *Id*.
[173] *Id*.
[174] *Id*.
[175] *Id*. at 213.

D. *Voss v. Commissioner*

In *Voss v. Commissioner*, the Ninth Circuit reversed the Tax Court's decision in *Sophy*.[176] The Ninth Circuit was called upon to decide an issue of first impression: whether the acquisition indebtedness limitation and the home equity indebtedness limitation apply on a per-taxpayer basis or a per-residence basis if the qualified residence is owned by multiple unmarried taxpayers.[177] Inferring from the statute's treatment of married taxpayers filing separate returns, the Ninth Circuit held that the indebtedness limitations on qualified residence interest apply to unmarried co-owners on a per-taxpayer basis.[178] Thus, each co-owner is entitled to an aggregate $1.1 million indebtedness limitation amount.[179] Before reviewing the applicable statutory language, the Ninth Circuit noted that "[s]ection 163 of the Internal Revenue Code governs the deductibility of interest on a taxpayer's indebtedness. This section of the Tax Code, like much of the Code, is complex—it requires attention to definitions within definitions and exceptions upon exceptions."[180]

The Ninth Circuit began by stating that Congress could have drafted the statute to make clear whether the indebtedness limitations apply to unmarried co-owners of a qualified residence on a per-taxpayer basis or a per-residence basis.[181] Although the statute is silent on this point, the Ninth Circuit noted that it was not entirely without textual guidance.[182] The statute is clear as to the application of the indebtedness limitations to one type of co-ownership that of married individuals filing separate returns.[183] Both indebtedness limitations contain parenthetical language that allows only 50 percent of the indebtedness limitation amounts "in the case of a married individual filing a separate return."[184] Congress's use of the phrase "in the case of" suggests that the parentheticals are exceptions to the general indebtedness limitations.[185] This language also suggests "parallelism between the parenthetical language and the main clause of that provision."[186] The Ninth Circuit stated that the parenthetical

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176 Voss v. Comm'r, 796 F.3d 1051, 1053 (9th Cir. 2015).
177 *Id.* at 1057.
178 *Id.* at 1057–59.
179 *Id.* at 1068; *see supra* Part III B (discussing the Service's position in C.C.A. 200940030 and Revenue Ruling 2010-25, which allows the aggregation of the indebtedness limitations upon the acquisition, construction, or substantial improvement of a qualified residence). If a taxpayer's total mortgage indebtedness exceeds the limitations, the Tax Court provides the "usual" method for calculating qualified residence interest: multiply the total interest paid by a ratio of the statutory indebtedness limitation over total indebtedness. *Voss*, 796 F.3d at 1054 (citing Treas. Reg. § 1.163-10T(e) (1987)).
180 *Voss*, 796 F.3d at 1053.
181 *Id.* at 1058–59.
182 *Id.* at 1058.
183 *Id.*
184 *Id.* (quoting I.C.R. § 163(h)(3)(B) (2012)).
185 *Id.*
186 *Id.*

language offers three useful insights into the interpretation of the general indebtedness limitations.[187]

First, the parenthetical language clearly speaks in per-taxpayer terms in referring to a "married individual," even though married individuals commonly co-own their homes and are jointly and severally liable on any mortgage.[188] This per-taxpayer wording, along with the phrase "in the case of," suggests that the wording of the main clause, especially the phrase "aggregate amount treated," should be applied in a per-taxpayer manner.[189]

Second, the parenthetical language not only speaks in per-taxpayer terms but also operates in a per-taxpayer manner.[190] Each spouse filing a separate return is subject to aggregate indebtedness limitations of $550,000;[191] thus, spouses filing jointly are subject to an aggregate indebtedness limitations of $1.1 million, which are the indebtedness limitations for a single taxpayer.[192] The parentheticals do not subject both spouses jointly to aggregate indebtedness limitations of $550,000 but "ensur[e] that a married couple filing separate returns is treated the same as a couple filing a joint return."[193] Both the Service and the Tax Court agree that the parenthetical limitations apply on a per-spouse basis; therefore, the indebtedness limitations for unmarried individuals should also apply on a per-taxpayer basis.[194]

Third, the very inclusion of the parenthetical suggests that the indebtedness limitations apply on a per-taxpayer basis.[195] Applying the rule of statutory construction that a statute should not be interpreted in a way that renders a provision superfluous,[196] the Ninth Circuit concluded that the parenthetical language would be superfluous if the indebtedness limitations applied on a per-residence basis.[197] In that case, the parenthetical limiting two spouses filing separately to an indebtedness limitation of $550,000 each would be unnecessary.[198] The Tax Court's reasoning that Congress included the parenthetical language to establish a 50 percent allocation of the indebtedness limitations amount was unpersuasive.[199] Congress's inclusion of the parenthetical language merely to prevent spouses from otherwise allocating indebtedness limitation amounts is unlikely, especially as most married couples own their homes as equal partners.[200]

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187 *Id.*
188 *Id.*
189 *Id.* at 1059.
190 *Id.*
191 *Id.*
192 *Id.*
193 *Id.*
194 *Id.*
195 *Id.*
196 *Id.*
197 *Id.* at 1059–60.
198 *Id.* at 1060.
199 *Id.*
200 *Id.*

The Ninth Circuit noted that Congress has enacted a number of tax statutes that halved deductions, credits, or limitations for spouses filing separately.[201] Examples include: (1) I.R.C. section 22 (a credit for the elderly and the permanently or totally disabled); (2) I.R.C. section 1202 (a 50 percent exclusion for gain from the sale of certain small business stock); and (3) I.R.C. section 1211(b) (a deduction limit for excess capital losses).[202] Thus, demonstrating Congress's awareness that treating joint filers as one taxpayer and separate filers as two taxpayers ensures that separately filing couples do not receive double the benefit that jointly filing couples receive.[203] Finally, if Congress intended two or more unmarried taxpayers to be treated as a single taxpayer for the purpose of a particular deduction or credit, Congress could have used the necessary language.[204] For example, I.R.C. section 36(b) specifically limits the amount of the tax credit to $8,000 for first-time homebuyers regardless of the number of unmarried co-owners.[205]

In *Sophy*, upon close examination of the definitions of qualified residence interest, acquisition indebtedness, and home equity indebtedness, the Tax Court rejected the per-taxpayer interpretation of the indebtedness limitations, finding the general "focus" of the statute was on the qualified residence and the "conspicuous absence" of "any reference to an individual taxpayer."[206] However, the Ninth Circuit observed that the repeated reference to the residence was only natural in a statute providing a deduction for interest paid on indebtedness with respect to a qualified residence.[207] The Ninth Circuit stated that additional references to the taxpayer could have been included, but such additional references are unnecessary as "[a]ny reasonable reader would understand that the statute is speaking of a taxpayer."[208]

Finding nothing in the statute to support the Tax Court's per-residence interpretation, the Ninth Circuit found several provisions of the statute that support a per-taxpayer interpretation.[209] First, the definition of "qualified residence interest" refers to interest paid during the "taxable year," and the indebtedness limitations refer to "for any period," clearly referring to the "taxable year."[210] Taxpayers, not residences, have tax years, and taxpayers may have different tax years.[211] Nevertheless, I.R.C. section 163(h) speaks in terms of a single tax year, implying that the indebtedness limitations apply on a per-taxpayer ba-

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201 *Id.*
202 *Id.*
203 *Id.*
204 *Id.* at 1061.
205 *Id.*
206 *Id.* (quoting Sophy v. Comm'r, 138 T.C. 204, 210–11 (2012)).
207 *Id.* at 1062.
208 *Id.*
209 *Id.* at 1063.
210 *Id.* (internal quotation marks omitted).
211 *Id.*

sis.[212] Moreover, under the per-residence approach, the method of applying the indebtedness limitations to co-owners with different tax years is unclear.[213]

The Ninth Circuit also found the Tax Court's per-residence interpretation difficult to reconcile with the statute's definition of "qualified residence."[214] I.R.C. section 163(h)(4)(A) defines qualified residence as

> the principal residence (within the meaning of section 121) of the taxpayer, and 1 other residence of the taxpayer which is selected by the taxpayer for purposes of this subsection for the taxable year and which is used by the taxpayer as a residence (within the meaning of section 280A(d)(1)).[215]

If the taxpayer owns multiple secondary residences, the taxpayer can annually select a different residence as the other residence.[216] The definition of a qualified residence clearly focuses on the taxpayer.[217] In addition, the Tax Court's per-residence approach would be difficult to apply to co-owners of a residence each having a different qualified residence.[218] By contrast, a per-taxpayer approach would be easy to apply to co-owners with multiple residences.[219] The Ninth Circuit opinion included the following example:

> [T]wo individuals might each have a separate primary residence but go in together on a vacation home in Maui. For such co-owners, filing tax returns under the Tax Court's per-residence approach would be like running a three-legged race. The co-owners are tied together for one home but not the other. This would mean that the two (or it could be three or four) co-owners would have to coordinate their tax returns to ensure that the aggregate amount of acquisition debt for each taxpayer's "qualified residence" does not exceed $1 million. It would also mean that one co-owner's deduction might depend on the size of another co-owner's mortgage on a home in which the first co-owner has no interest.[220]

Finally, the fact that the parenthetical language creates a marriage penalty is not of significant concern to the Ninth Circuit.[221] The Ninth Circuit noted that "Congress may have had perfectly legitimate reasons for distinguishing between married and unmarried taxpayers."[222] Significant tax benefits may result to a married couple opting to file a joint return, such as lower tax rates at various income levels.[223] Further, if a married taxpayer filing a separate return is limited to an aggregate of $550,000 of indebtedness, implicitly, a married cou-

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212 *Id.*
213 *Id.*
214 *Id.*
215 *Id.* at 1063–64 (quoting I.R.C. § 163(h)(4)(A)(i) (2012)) (internal quotations omitted).
216 *Id.* at 1064.
217 *Id.*
218 *Id.*
219 *Id.*
220 *Id.*
221 *Id.* at 1065.
222 *Id.*
223 *Id.*

ple filing a joint return is limited to an aggregate of $1.1 million of indebtedness.[224] The apparent purpose of the parenthetical is to ensure that married couples are treated as a single taxpayer regardless of whether they file separately or jointly.[225] Nevertheless, the Ninth Circuit noted:

> If two individuals who are engaged to be married each own their own house and each have their own $1 million mortgage, both get to deduct all of their interest. But if they get married and file a joint return, they are treated as one taxpayer and can then only deduct half of their interest.[226]

E. Voss Dissent

The dissent in *Voss* laments that the interpretation by the majority of the indebtedness limitations allows unmarried taxpayers, who buy "an expensive residence," to deduct twice the amount of the interest paid on indebtedness than married taxpayers.[227] Since the language of the statute is ambiguous, the reasonable interpretation by the Service that limits unmarried taxpayers to the same amount of qualified residence interest deduction as married taxpayers filing jointly should be given deference.[228]

In C.C.A. 200911007, the Service's application of the statute is straightforward.[229] With regards to a single taxpayer, only interest payments on a maximum of $1.1 million of indebtedness are deductible under I.R.C. section 163(h)(3).[230] Similarly, a married couple filing jointly is subject to the $1.1 million indebtedness limitations, which is consistent with the typical treatment of a married couple filing jointly as one taxpayer under the I.R.C.[231] As to an unmarried co-owner, the Service interpreted the statute to limit the deduction of qualified residence interest to a maximum of $1.1 million of indebtedness.[232]

The dissent rejects the taxpayer's interpretation of I.R.C. section 163(h)(3) as contrary to the Service's reasonable and persuasive interpretation of the statute in C.C.A. 200911007.[233] The plain meaning of the statute does not compel the taxpayer's interpretation that the indebtedness limitations apply on a per-taxpayer basis, allowing unmarried co-owners double the deductible interest of

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224 *Id.* at 1067.
225 *Id.* at 1065.
226 *Id.*
227 *Id.* at 1068 (Ikuta, J., dissenting).
228 *Id.*
229 *Id.* at 1069; *see supra* Part IV B (discussing the Service's position in C.C.A. 200911007 that the acquisition indebtedness limitation applies on a per-residence basis).
230 *Voss*, 796 F.3d at 1069 (Ikuta, J., dissenting); *see supra* text accompanying notes 95 and 105 (discussing the Service's position in C.C.A. 200940030 and Revenue Ruling 2010-25, which allows for the aggregation of the indebtedness limitations upon the acquisition, construction, or substantial improvement of a qualified residence).
231 *Voss*, 796 F.3d at 1069 (Ikuta, J., dissenting).
232 *Id.* at 1069–70.
233 *Id.* at 1071.

single taxpayers or married taxpayers filing jointly.[234] Rather, the statute does not indicate how the indebtedness limitations are to be applied to multiple co-owners. In such a circumstance, "we can afford respect to an agency's interpretation of a statute, whether it is offered in an opinion letter, policy statement, agency manual, or even a well-reasoned legal brief."[235] The dissent further states that the measure of deference to which an agency's interpretation is entitled is proportional to the "thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade."[236]

In response, the majority agrees that C.C.A. 200911007 is entitled to the "measure of deference proportional to the 'thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade.'"[237] Applying these factors, the majority suggests that C.C.A. 200911007 should be given "limited weight."[238] The majority held the one-paragraph analysis interpreting the application of the statute to unmarried co-owners was neither thorough nor exhaustive.[239] C.C.A. 200911007 treats the question as governed by the "plain language of the statute."[240] However, the majority finds that the briefs of the parties, the Tax Court decision, and the statute itself demonstrate that the statute's language is anything but plain.[241] The approach taken in C.C.A. 200911007 was not a consistent position, established understanding, or comparable consensus of the Service.[242] Other than the Service's litigation po-

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[234] *See id.*

[235] *Id.* (citing Christensen v. Harris Cty., 529 U.S. 576, 587 (2000)).

[236] *Id.* (quoting United States v. Mead Corp., 533 U.S. 218, 228 (2001)). The dissent supported the position taken by the Service in C.C.A. 200911007 as reasonable and persuasive, arguing: (1) the Service's interpretation is consistent with the text of the statute that can be read to establish indebtedness limitations of $1.1 million per qualified residence regardless of the number of co-owners; (2) the Service's interpretation does not result in a windfall to unmarried taxpayers; and (3) the Service has consistently applied its interpretation of the I.R.C. section 163(h)(3) indebtedness limitations. *Id.* at 1071–72. The dissent stated: "A more logical inference is that the deduction was aimed at promoting home ownership for ordinary folks, not to help wealthy individuals purchase mansions that are encumbered with more than $1.1 million of debt." *Id.* at 1072. Disagreeing with the analysis of the majority, the dissent further argues, in summary: (1) other than referencing the definition of a "qualified residence," nothing indicates that either Congress or the Service contemplated that the approach used in I.R.C. section 121 should determine the amount of indebtedness limitations under I.R.C. section 163(h)(3); (2) the parenthetical language does not provide textual support for a per-taxpayer approach; and (3) there are practical difficulties in determining the amount of qualified residence interest deduction of each unmarried co-owner under a per-residence interpretation. *Id.* at 1072–75.

[237] *Id.* at 1066 (majority opinion) (quoting Christopher v. Smith Kline Beecham Corp. 132 S. Ct. 2156, 2168–69 (2012)).

[238] *Id.*

[239] *Id.*

[240] *Id.* (quoting C.C.A. 200911007, *supra* note 134, at 4).

[241] *Id.*

[242] *Id.*

sition in this case, C.C.A. 200911007 is the only pronouncement addressing how the indebtedness limitations apply to unmarried co-owners of a qualified residence.[243] "The agency's guidance is closer to a 'mere[] . . . litigating position' than to an 'agency interpretation of 'longstanding' duration.' "[244] Further, the majority states:

> At bottom, although an IRS Chief Counsel Advice statement "is helpful in determining the position of the IRS," it is an internal IRS memorandum prepared by an individual IRS attorney. The document itself cautions that it "may not be used or cited as precedent." Indeed, the IRS could issue a memorandum taking the opposite position tomorrow, "apparently without revoking the earlier guidance."[245]

V. ACTION ON DECISION 2016-02

In Action on Decision ("A.O.D.") 2016-02, the Service acquiesced to the Ninth Circuit's decision in *Voss*.[246] In *Voss*, the Ninth Circuit held that the acquisition indebtedness limitation and the home equity indebtedness limitation apply to unmarried co-owners of a qualified residence on a per-taxpayer basis rather than a per-residence basis.[247] In A.O.D. 2016-02, the Service announced that it will follow the *Voss* opinion and apply the indebtedness limitations on a per-taxpayer basis.[248] Each unmarried co-owner of a qualified residence will be allowed to deduct interest paid on a maximum of $1 million of acquisition indebtedness and $100,000 of home equity indebtedness pursuant to I.R.C. section 163(h)(3).[249] The Service noted that the Ninth Circuit based its conclusion largely on its interpretation of the parenthetical language expressly providing that married individuals filing separate returns are entitled to deduct interest on a maximum of $500,000 of acquisition indebtedness and $50,000 of home equity indebtedness.[250] "By providing lower debt limits for married couples, and not for unmarried co-owners, Congress singled out married couples for specific treatment, implying that an unmarried co-owner filing a separate return is entitled to deduct interest on up to $1,000,000 of acquisition indebtedness and $100,000 of home equity indebtedness."[251]

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243 *Id*.
244 *Id*. at 1066–67 (quoting Alaska Dep't of Envtl. Conservation v. E.P.A., 540 U.S. 461, 487–88 (2004)).
245 *Id*. at 1067–68 (internal citations omitted).
246 Voss v. Comm'r, 796 F.3d 1051 (9th Cir. 2015), *action on dec*., 2016-02 (Aug. 1, 2016).
247 *Voss*, 796 F.3d at 1068; *see supra* Part IV D (discussing the Ninth Circuit's decision in *Voss*, which held that the I.R.C. section 163(h)(3) indebtedness limitations apply to unmarried co-owners on a per-taxpayer basis).
248 *Voss*, 796 F.3d 1051, *action on dec*., 2016-02, at 2.
249 *Id*. at 1–2.
250 *Id*. at 1.
251 *Id*. at 1–2.

Prior to 1991, the Service only published acquiescence or nonacquiescence in certain Tax Court decisions.[252] Since that time, the Service has expanded its acquiescence program to include other civil tax cases, including cases before District Courts, Claims Courts, and Circuit Courts.[253] The purpose of an A.O.D is to provide guidance to Service personnel working with the same or similar issues.[254] An A.O.D. will be relied on within the Service merely as the application of the tax law to the facts of a particular case at the time the A.O.D. was issued.[255] "[A]cquiescence" means that the Service accepts the holding of the court and "will follow it in disposing of cases with the same controlling facts."[256] Unlike Treasury Regulations and Revenue Rulings, an A.O.D. is not an affirmative statement of the Service's position, "[i]t is not intended to serve as public guidance and may not be cited as precedent."[257] An A.O.D. may be superseded by new legislation, regulations, rulings, cases, or future A.O.D.'s.[258]

With the Service's acquiescence to the *Voss* decision, only Congress can provide the necessary clarity and certainty in the application of this commonly used tax provision. Congress must decide whether the application of the indebtedness limitations on a per-taxpayer basis is proper from a tax, fiscal, and social policy perspective and legislate accordingly:

> Had Congress wanted to make clear that the debt limits apply per taxpayer, it could have drafted the provisions to limit "the aggregate amount *each taxpayer* may treat as" acquisition or home equity debt. But it did not. Or, had Congress wanted to make clear that the debt limits apply per residence, it could have provided that the debt limits must be divided or allocated in the event that two or more unmarried individuals co-own a qualified residence.[259]

VI. SHOULD THE DEDUCTION FOR QUALIFIED RESIDENCE INTEREST BE REPEALED OR AMENDED?

Should the deduction for qualified residence interest continue in its current form, be repealed or substantially limited, or replaced with an income tax credit? Congress should address this question because the qualified residence interest deduction is very costly. The Joint Committee on Taxation estimates that, for fiscal years 2015 through 2019, the deduction of qualified residence interest on owner-occupied residences will cost the federal government $419.8 billion in forgone tax revenue.[260] This tax expenditure costs an estimated $85 billion

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[252] Actions Relating to Decisions of the Tax Court, 2016-31 I.R.B. 193 (Aug. 1, 2016).
[253] *Id.*
[254] *Id.*
[255] *Id.*
[256] *Id.*
[257] *Id.*
[258] *Id.*
[259] Voss v. Comm'r, 796 F.3d 1051, 1058 (9th Cir. 2015) (emphasis in original).
[260] JOINT COMM. ON TAXATION, 114TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2015–2019, at 32 tbl.1 (Comm. Print 2015).

more than the combined tax cost of the deduction for real property taxes[261] and the exclusion of capital gains on the sale of a principal residence.[262] The Department of the Treasury, Office of Tax Analysis, estimates that, for fiscal years 2015 through 2025, the deduction of qualified residence interest will result in $948.5 billion in foregone tax revenue[263] and is ranked fourth in tax expenditures only behind: (1) exclusion from income of employer contributions to medical insurance premiums and medical care; (2) exclusion of net imputed rental income of owner-occupants of a residence; and (3) the lower tax rate for capital gains, excepting agriculture, timber, iron ore, and coal.[264] The Service's acquiescence to the application of the indebtedness limitations on a per-taxpayer basis will only increase the cost of this tax preference in foregone revenue.

In addition to viewing tax incentives as direct government spending administered through the tax code, the particular policy objective the tax incentive is intended to achieve should also be analyzed.[265] The deductibility of qualified residence interest has been defended on the ground that the deduction promotes tax fairness between taxpayers who own residences without a mortgage and taxpayers who own residences with a mortgage.[266] Then again, homeowners already receive a tax advantage by not being taxed on imputed rental income as the owner occupant of the residence, and homeowners with a mortgage would have less imputed rental income than the homeowner without a mortgage because of the deductible interest expense.[267] Of course, taxpayers who do not own but rent their residence receive neither the tax benefit of the exclusion of imputed rent nor the deduction for qualified residence interest.[268] Further, this tax incentive is limited to taxpayers with home mortgages and no tax consideration is given to purchasers of other consumer durables, such as automobiles.[269] The Staff of the Joint Committee on Taxation, in its explanation of the amendments to I.R.C. section 163 by the Tax Reform Act of 1986, stated: "While Congress recognized that the imputed rental value of owner-occupied housing may be a significant source of untaxed income, the Congress nevertheless de-

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261 *See* I.R.C. § 164(a)(1) (2012).

262 *See id.* § 121; JOINT COMM. ON TAXATION, *supra* note 260, at 32 tbl.1 (subtracting the total deduction for property taxes on real property ($184.5 billion) and the total Exclusion of capital gains on sales of principal residences ($149.9 billion) from the total deduction for mortgage interest on owner-occupied residences ($419.8 billion)).

263 U.S. DEPT. OF TREASURY, OFFICE OF TAX ANALYSIS, TAX EXPENDITURES 22 tbl.1, 30 tbl.2b (2015).

264 *Id.* at 33 tbl.3.

265 *See generally* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970).

266 BITTKER ET AL., *supra* note 44, ¶ 22.02, at 22-3.

267 *Id.* ¶ 22.02, at 22-4.

268 *Id.*

269 *Id.*; *see* MCDANIEL ET AL., *supra* note 16, at 748 (discussing the policy of allowing a deduction for home mortgage interest and real property tax on personal residences).

termined that encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest."[270]

The most common criticism of the qualified residence interest deduction is that the deduction benefits the highest-income taxpayers.[271] Several factors contribute to this deduction being more valuable to high-income taxpayers than low-income taxpayers.[272] First, as a result of the progressive rate structure of the federal income tax, the value of an itemized deduction depends on the taxpayer's marginal rate.[273] For example, a taxpayer with a top marginal rate of 39.6 percent would save $39.60 from an additional $100 of qualified residence interest deduction whereas a taxpayer with a top marginal rate of 25 percent would save only $25.

Second, to claim a deduction for qualified residence interest, taxpayers must itemize their deductions rather than claim a standard deduction in filing their federal tax returns.[274] Although real estate, home building, and mortgage lending organizations attempt to portray the qualified residence interest deduction as vital to the middle class,[275] the analysis of the data by the Joint Committee on Taxation tells a different story. For the 2014 tax year, the Joint Committee on Taxation determined that only approximately 39 percent of taxpayers itemized their deductions.[276] Further, low-income taxpayers tend not to own residences, or, if a residence is owned, the purchase price and correspondingly the mortgage is generally less than high-income taxpayers.[277] The President's Advisory Panel on Federal Tax Reform has criticized the qualified residence interest deduction for primarily encouraging construction of larger homes and not necessarily broadening home ownership among the middle-income taxpayers.[278]

Recently, numerous proposals to modify the qualified residence interest deduction have emerged, including the following alternatives and considerations: (1) retain the current deduction; (2) repeal the current deduction; (3) limit the current deduction; or (4) replace the current deduction with a credit.

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270 JOINT COMM. ON TAXATION, *supra* note 27, at 263–64.

271 *See, e.g.*, WILL FISCHER & CHYE-CHING HUANG, CTR. ON BUDGET & POLICY PRIORITIES, MORTGAGE INTEREST DEDUCTION IS RIPE FOR REFORM 1 (2013).

272 *See id.* at 3; Gerald Prante, *Who Benefits from the Home Mortgage Interest Deduction?*, TAX FOUND. (Feb. 6, 2006), http://taxfoundation.org/article/who-benefits-home-mortgage-interest-deduction [https://perma.cc/4UBA-Z9FR].

273 FISCHER & HUANG, *supra* note 271, at 4; Prante, *supra* note 272.

274 FISCHER & HUANG, *supra* note 271, at 2; Prante, *supra* note 272.

275 *See* Prante, *supra* note 272.

276 JOINT COMM. ON TAXATION, *supra* note 260, at 43 tbl.2 (dividing the total Itemized Return (45,953) by the Total Returns (168,943)).

277 FISCHER & HUANG, *supra* note 271; Prante, *supra* note 272.

278 PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 73–74 (2005).

A. Retain the Current Deduction

I.R.C. section 163(h)(3) could remain in its current form. The qualified residence interest deduction is popular among homeowners and industry groups, such as the National Association of Realtors, the National Association of Homebuilders, and the Mortgage Bankers Association.[279] Although it is generally believed to promote the buying of homes,[280] economic research suggests that the deduction may not achieve the policy objective of an increase in homeownership.[281]

B. Repeal the Current Deduction

Congress could repeal the qualified residence interest deduction, which is an exception to the general disallowance of deductions for personal interest. The repeal of I.R.C. section 163(h)(3) would help promote the more uniform treatment of taxpayers. Taxpayers owning or renting their home or living in different parts of the country[282] would have greater tax equality.[283] It would also increase federal revenue, improving the long-term budgetary situation of the United States.[284]

With regard to the potential effect on homeownership, economists have identified the primary barrier to homeownership to be the high transactional costs of purchasing a home, especially the requirement of a down payment.[285] Since the qualified residence interest deduction does not address this primary barrier and does not target the group of potential homebuyers most in need of assistance, namely, lower-income households, the effect on homeownership of eliminating the deduction is likely to be minimal over the long term.[286] However, the repeal of the qualified residence interest deduction may have negative consequences to the economy in the short term.[287] For example, the sudden elimination of the deduction could cause a drop in home demand with a corresponding drop in home prices.[288] The decrease in home prices could lead to a

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279 KEIGHTLEY, *supra* note 8, at 10.

280 *Id.*

281 *Id.*; *see* Christian A. L. Hilber & Tracy M. Turner, *The Mortgage Interest Deduction and Its Impact on Homeownership Decisions*, 96 REV. ECON. & STAT. 618, 618–19 (2014) (examining the impact of the combined state and federal mortgage interest deduction on homeownership attainment).

282 *See* KEIGHTLEY, *supra* note 8, at 10 (analyzing the variation in the mortgage interest deduction tax expenditure across the states); *see also* Patricia A. Cain, *Unmarried Couples and the Mortgage Interest Deduction*, 123 TAX NOTES 473, 473–74 (2009) (discussing the indebtedness limitations in relation to home prices in certain areas of the United States, especially California).

283 *See* KEIGHTLEY, *supra* note 8, at 10.

284 *Id.*

285 *Id.* at 11.

286 *Id.*

287 *Id.*

288 *Id.*

reduction in new home construction, a reduction in homeowner wealth, and, possibly, an increase in mortgage defaults.[289] Gradually phasing out the qualified residence interest deduction over a period of time may mitigate the negative consequences to the economy and the housing market.[290]

C. Limit the Current Deduction

Currently, taxpayers may deduct interest on $1 million of acquisition indebtedness and $100,000 of home equity indebtedness, secured by their principal residence or a second designated residence.[291] The tax equity of the qualified residence interest deduction would be greatly increased, and the tax cost of the interest deduction would be greatly decreased, if the indebtedness limitations were reduced and/or the type of indebtedness was limited only to acquisition indebtedness.[292] Another option would be to retain the current indebtedness limitations but limit the amount of the interest deduction to a percentage of the taxpayer's adjusted gross income.[293] With regard to the long-standing tradition of allowing an interest deduction for indebtedness secured by a second home, the nonpartisan Tax Policy Center offered a rough estimate that repealing the deduction for second homes could generate $8 billion in tax revenues annually.[294] With the Service's acquiescence to the *Voss* decision, the tax equity of the qualified residence interest deduction would be greatly increased, and the tax cost of the interest deduction would be greatly decreased, if Congress legislated that the indebtedness limitations apply on a per-residence basis.[295]

D. Replace the Current Deduction with a Credit

Several proposals have been advanced to replace the qualified residence interest deduction with a tax credit.[296] The current deduction provides a proportionally larger tax benefit to upper-income taxpayers since they tend to buy more expensive homes and are subject to higher marginal tax rates.[297] Also, the

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[289] *Id.*
[290] *Id.*
[291] I.R.C. § 163(h)(3) (2012).
[292] *See* CONG. BUDGET OFFICE, PUB. NO. 3191, BUDGET OPTIONS VOL. 2, at 187 (2009).
[293] KEIGHTLEY, *supra* note 8, at 12.
[294] Richard Rubin, *Second-Home Deduction Future Depends on Congress Using It*, BLOOMBERG (July 23, 2013, 8:26 AM), http://www.bloomberg.com/news/articles/2013-07-23/second-home-deduction-future-depends-on-congress-using-it [https://perma.cc/N437-NVN4].
[295] *See supra* Part V (discussing the Service's acquiescence to the *Voss* decision and the possible need for legislation).
[296] *See* AMANDA ENG ET AL., TAX POLICY CTR., URBAN INST. & BROOKINGS INST., OPTIONS TO REFORM THE DEDUCTION FOR HOME MORTGAGE INTEREST 2 (2013) (considering a proposal to repeal the current deduction and define eligible mortgage interest as interest incurred on up to $500,000 of an eligible mortgage and allowing a nonrefundable credit of 15 percent or, in the alternative, 20 percent of eligible mortgage interest).
[297] KEIGHTLEY, *supra* note 8, at 13.

fact that taxpayers must itemize their deductions before taking advantage of the qualified residence interest deduction also limits the number of taxpayers who can take advantage of this tax preference.[298] A credit, unlike a deduction, has the same dollar-for-dollar value to taxpayers regardless of their income level.[299] Making the credit refundable would make this tax preference better targeted to lower-income homeowners.[300] Substituting a tax credit for the qualified residence interest deduction would provide a dollar-for-dollar tax benefit for all taxpayers and be of greater benefit to lower-income homeowners.

Five of the most prominent tax credit options are summarized as follows:

> Over the years, several mortgage interest tax credit options have been proposed. . . . All five would limit the deduction to a taxpayer's principal residence. Four out of the five would allow a 15% credit rate. Three of the five credit options would be nonrefundable. Two of the options would limit the size of the mortgage eligible for the credit to $500,000, while one would limit eligible mortgages to no greater than $300,000 (with an inflation adjustment). Another would limit the maximum eligible mortgage to 125% of the area median home prices. And still another would place no cap on the maximum eligible mortgage, but would limit the maximum tax credit one could claim to $25,000.[301]

CONCLUSION

The questions of social and economic policy raised by I.R.C. section 163(h)(3) will continue to generate discussion and scholarship. The issues addressed in *Sophy* and *Voss*, the application of the qualified residence interest deduction and the level of judicial deference given the varied pronouncements by the Service, will undoubtedly be subject to litigation and legislation in the future. Complicating the evaluation of the statute are concerns regarding the fairness of a tax incentive given to homeownership, the even greater tax benefit to wealthy taxpayers, the dramatic geographic disparity in the cost of homeownership, the proliferation of the marriage penalty, and the disparate treatment of married and unmarried cohabitants. The acquiescence of the Service to the *Voss* decision, applying the indebtedness limitations on a per-taxpayer basis, has assured a greater tax preference to higher-income taxpayers and unmarried, co-owners of residences. This seemingly simple statute has required a very deliberate analysis of its language, congressional intent, and policy implications, and a methodical application of almost the entire inventory of the rules of statutory interpretation.

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[298] *Id.*
[299] *Id.*
[300] *Id.*
[301] *Id.*