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# Unmarried Couples and the Mortgage Interest Deduction

Patricia A. Cain
*Santa Clara University School of Law*, pcain@scu.edu

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By Patricia A. Cain

Patricia A. Cain is the Inez Mabie Distinguished Professor of Law at Santa Clara University. The author is in a long-term committed relationship that is not recognized as a marriage under federal tax law. She and her partner/spouse recently moved from Iowa to Northern California, where the housing prices are considerably higher than in the rest of the country. See note 8, *infra.*

In 2006, I complained in *Tax Notes* about the issuance of chief counsel advice (ILM 200608038 (Feb. 24, 2006), *Doc 2006-3875*, *2006 TNT 39-13*) that concluded *Poe v. Seaborn*, 282 U.S. 101 (1930), did not apply to the community earnings of California registered domestic partners (RDPs).[1] Because the state law that causes *Poe v. Seaborn* to apply to California[2] spouses is exactly the same state law that applies to RDPs, it is difficult to understand why spouses reporting separately at the federal level must split their community earnings and RDPs cannot. As I argued in that article, *Poe v. Seaborn* is a case about state property rights, not marriage. Further, if *Seaborn* is to be reversed or not applied to RDPs, it is up to Congress and not the IRS to make that determination.

Tax practitioners and return preparers in California have managed to muddle through the community property tax problems of their RDP clients for more than three years. No one is clear about which community property rules the IRS is likely to apply to California RDPs — apart from the narrow rule in the chief counsel advice requiring each partner to report his own personal service earnings. Even those who feel bound to follow the chief counsel advice wonder aloud how it came to be that the only published rule on taxation of RDPs is contained in a written determination that, by law, cannot be used or cited as precedent.[3]

It now appears that the IRS has decided to create another "nonprecedent" rule for many same-sex, as well as unmarried opposite-sex, couples in California. An internal legal memorandum issued to an IRS attorney in San Francisco last November (ILM 200911007 (Nov. 24, 2008), *Doc 2009-5566*, *2009 TNT 48-15*), but not released until March 2009, deals with the question of how to compute the limitation on mortgage interest deductions for unmarried couples.

Section 163(h)(3) authorizes a deduction for any mortgage interest paid on acquisition indebtedness incurred to purchase or improve a principal residence or a secondary residence. The provision was enacted in 1986 and revised in 1987. In the 1987 revision, Congress limited the amount of acquisition indebtedness interest that a taxpayer could claim. It did so by capping the amount of debt that could be treated as acquisition debt. The code provides that the "aggregate amount treated as acquisition indebtedness for any period shall not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return)."[4]

In 1987 the median price of a home at the national level, as reported by the National Association of Realtors, was $86,000.[5] By 2008 that number had more than doubled to $197,000.[6] So even now, most homeowners in the United States are not affected by the $1 million cap set by Congress. But those metropolitan area reports do not tell the whole story. In several towns and cities, especially in California, the median price of a single-family home is well above $1 million. This is especially true in Silicon Valley. Even though real estate prices are declining, the median price for a home in Palo Alto is $1.7 million.[7] Prices are similar in surrounding communities.[8] Comparable homes in other states sell at much lower prices.[9]

As a result of escalating home prices in California, there are many home buyers who do incur more than $1

[1]*See* Patricia A Cain, "Relitigating *Seaborn*: Taxing the Community Income of California Registered Domestic Partners," *Tax Notes*, May 1, 2006, p. 561, *Doc 2006-7375*, or *2006 TNT 84-33*.

[2]The rule announced in *Poe v. Seaborn* was extended to California spouses on the basis of the California community property system in *United States v. Malcolm*, 282 U.S. 792 (1931).

[3]*See* section 6110(j)(3).

[4]Section 163(h)(3)(B)(ii).

[5]*See* http://www.nytimes.com/1987/10/18/realestate/data-update-october-18-1987.html.

[6]National Association of Realtors, "Median Sales Price of Existing Single-Family Homes for Metropolitan Areas," *available at* http://www.realtor.org/research/research/metroprice.

[7]*See* http://www.altosresearch.com/research/CA/PALO+ALTO. And that figure is down from above $2 million in May 2008.

[8]In neighboring Menlo Park, the median price is $1.3 million, also down from 2008. Most of the cities neighboring Palo Alto are well above $1 million in median home prices (for example, Atherton, $4.2 million; Woodside, $2.15 million; Los Altos and Portola Valley, $1.8 million; Burlingame, $1.4 million; Los Gatos, $1.28 million; and Cupertino, $1.2 million). *Id*.

[9]*See, e.g.,* William J. Turnier and Grayson M.P. McCouch, *Family Wealth Management* at p. 342 (2005) (comparing 2005 median home prices between Cedar Rapids, Iowa, $150,000; Seattle, $281,000; San Francisco, $832,000; and Palo Alto, Calif., $1,009,000).

million in acquisition indebtedness for a single home. The recently released chief counsel advice sets forth a rule that is detrimental to many of those home buyers. It concludes that the $1 million acquisition debt limitation should be applied to the mortgage amount on a single home rather than to the taxpayer. For example, if A and B, two unrelated taxpayers, acquire a primary or secondary residence jointly and the joint mortgage exceeds $1 million, between them they could not deduct any mortgage interest on the amount of debt above $1 million. Specifically, the chief counsel advice requires that each taxpayer deduct only a pro rata share of the mortgage interest paid by each. The amount of deductible interest is based on a fraction, the numerator of which is $1 million and the denominator of which is the average outstanding balance of the mortgage. Thus, if A and B jointly purchase a residence for which they incur a $2 million purchase money mortgage liability, with the understanding that each will pay $1 million of the total liability, each taxpayer's mortgage interest deduction would be limited to 50 percent of the total amount of interest paid, rather than 100 percent of the interest paid on each taxpayer's $1 million of debt. By contrast, if A purchased a separate residence and incurred a $1 million purchase money mortgage, A would be entitled to deduct 100 percent of the interest paid on the $1 million debt.[10]

The only rationale offered in the chief counsel advice is that section 163(h)(3) defines acquisition indebtedness as indebtedness that is incurred in acquiring a ''qualified residence''[11] and not a ''*portion* of a qualified residence.'' (Emphasis in the original.) Qualified residence is not separately defined in section 163(h)(3). Instead, the definition is incorporated from section 121, the provision that excludes from taxation a portion of the gain from the sale of a principal residence. Under section 121, if there are two or more unrelated owners, each is viewed as owning his undivided interest as a separate principal residence to which the section 121 exclusion applies. It seems inconsistent, therefore, to say that joint owners can be viewed as each owning a separate residence for purposes of section 121 but not for section 163(h)(3), when the definition of qualified residence is controlled by section 121.

Consider also the following language from the Joint Committee on Taxation's general explanation of the 1986 enactment of the new mortgage deduction rules:

> 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.[12]

Although that language does not directly address the $1 million limitation, which was added in 1987, it does make clear that the purchase of a qualified residence was intended to include the purchase of an undivided interest in a qualified residence.

Granted, the $1 million limitation is not drafted clearly. The statutory language provides that the ''aggregate amount treated as acquisition indebtedness for any period shall not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return).''[13] Nowhere does the statute clarify whether the $1 million limit is per taxpayer, and nowhere does it expressly state what the limit is for a married individual filing jointly. That has been a problem since the day the provision was enacted, and it is a problem that has never been addressed by regulations (in which interpretations of ambiguous statutory language are generally addressed after sufficient opportunity for public comment). Even so, once you work through the possible constructions, only one possibility seems clear.

Consider that in 2001 the IRS addressed for the first time the issue of whether the limits under section 163(h)(3) that are applied to a married couple filing separately should also apply to a married couple filing jointly.[14] In FSA 200137033 (June 18, 2001), *Doc 2001-23733*, *2001 TNT 180-13*, the IRS noted:

> The statute is silent on the issue of whether a married couple filing jointly is treated as one taxpayer, who may only have one principal residence and one other residence for both spouses, or whether each spouse may have his or her own separate principal residence plus his or her own separate other residence.

The FSA concluded:

> Although § 163(h)(4)(A) does not specifically state that a married couple filing jointly is treated as one taxpayer for purposes of determining their mortgage interest deductions, we assume that Congress did not intend to treat married couples filing jointly differently than married couples filing separately. Thus, a married couple filing jointly would also be treated as one taxpayer and would be entitled to take into account only a principal residence and one other residence for purposes of calculating their mortgage interest deduction.

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[10]Assume a joint note in the amount of $2 million at 7 percent. A pays half of the interest, $70,000, but his interest deduction is limited to $35,000 under the chief counsel advice. If, instead, A had purchased a home for himself at half the value and half the mortgage ($1 million instead of $2 million), A would be entitled to the full $70,000 deduction (subject to phaseouts under section 68).

[11]*See* section 163(h)(3)(B)(i)(I).

[12]*See* Joint Committee on Taxation, 99th Cong., General Explanation of the Tax Reform Act of 1986, 267 (Comm. Print 1987).

[13]Section 163(h)(3)(B)(ii).

[14]There are two types of limits in section 163(h)(3). There is the dollar limitation ($1 million for acquisition debt and $100,000 for home equity debt) and the several-homes limitation (one primary residence and one secondary residence). The dollar limitation is applied to the aggregate amount of debt outstanding that is secured by either the primary residence or a secondary residence. *See* section 163(h)(4)(A)(i) for the definition of qualified residence.

Further, regarding the dollar limitation, the FSA stated:

> The maximum amount of outstanding loans which a taxpayer, other than a married individual filing separately, may take into account for purposes of calculating a mortgage interest deduction is up to $1,000,000 for acquisition indebtedness and up to $100,000 for home equity indebtedness on the taxpayer's qualified residence.

And, as with the number of residences limitation, the FSA concluded that a married couple, whether filing separately or jointly, should be limited to interest deductions on $1 million of acquisition debt and $100,000 of home equity debt — in the aggregate, not per residence. In other words, the FSA clearly viewed the dollar limitations as applying *per taxpayer* but then also concluded that a married couple should be treated as one taxpayer.

The IRS could have concluded that spouses are two individual taxpayers, with each spouse entitled to a $1 million acquisition debt limit. There is nothing in the statutory language that commands one construction over the other. And, as a historical matter, spouses have been treated as separate taxpayers if they each had income. Indeed, before 1948, each spouse reported his income separately. But rather than treat two spouses as two taxpayers, the IRS felt constrained by the parenthetical provision in section 163(h)(3)(B)(ii) that restricted separately reporting spouses to a single $1 million limit. So the FSA opted for a rule of construction that would treat all married couples the same no matter how they elected to file their tax returns.

One can easily understand that an IRS that believes all married couples are limited by section 163(h)(3) to interest deductions on only $1 million of aggregate acquisition indebtedness might be reluctant to conclude that two partners in a same-sex relationship, or in any type of unmarried partnership, should be able to claim interest deductions on $2 million of debt. But if there has been one principle consistently running through tax law in recent years, especially since the enactment of the Defense of Marriage Act (DOMA) in 1996,[15] it is that unmarried couples cannot be treated the same as married couples. Differential treatment of married and unmarried couples may not be wise tax policy, but it is the current law. It is astounding that, in this environment, chief counsel would issue an opinion concluding that unrelated taxpayers who buy a home together must be treated the same as a married couple, even though they are not treated the same under any other tax code provision that spells out a special rule for spouses.[16]

Consider the situation of the taxpayers in the recently released IRS legal memorandum. Taxpayer A purchases a home and incurs acquisition indebtedness of $2 million. He can deduct mortgage interest on only 50 percent of the debt because his limit on acquisition debt is $1 million. Some years later, he transfers a 50 percent interest in the home to his partner, taxpayer B. The memorandum does not clarify how that transfer occurred. It is possible that B was simply added to the title and agreed to pay 50 percent of the outstanding mortgage debt. In that case, because A and B are unmarried, A would have made a taxable gift to B valued at approximately 50 percent of the equity in the home, less the annual exclusion amount.[17] If B instead paid for his 50 percent interest, A would have had a gain to the extent the home's value had appreciated since the original acquisition. Under section 121, the gain would probably have been excluded from income by A to the extent it did not exceed $250,000, but that gain would prevent A from claiming a full $250,000 exclusion on a later sale of his interest in the property. Of course, if A and B had been married, there would have been no taxable gift and no possibility of taxable gain on a transfer of ownership. That is because spouses have a special rule that covers interspousal transfers, a rule that is not available to unmarried partners.[18] That differential treatment should be consistent. If A and B are not treated the same as a married couple when they transfer an interest in the home between themselves, why should they be treated the same as a married couple when they pay their mortgage interest?

Another reason for reading the $1 million limit as one that applies per taxpayer rather than per residence or per mortgage, is that the rule requires calculation of aggregate acquisition indebtedness. Only a taxpayer can aggregate his indebtedness.[19]

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[15]The Defense of Marriage Act, 1 U.S.C. section 7 (1996), prevents even married same-sex couples from being treated the same as spouses.

[16]*See, e.g.,* sections 1, 267, 1041, 2040, and 2056.

[17]And less any fractional share discount that A would be entitled to claim because the gift is of an undivided interest in the property.

[18]*See* section 1041.

[19]The statute limits acquisition indebtedness to an aggregate amount of indebtedness not to exceed $1 million. Section 163(h)(3)(B)(ii). If the taxpayer has several acquisition debts, he is expected to add them together to determine if they exceed the limitation. Thus it is the taxpayer who is aggregating his total amount of outstanding debt per tax period. For the purpose of determining the interest deduction, however, the precise allocation is not among the various types of debt. Rather, it is an allocation of the interest to the debt that is being paid. Interest that is allocated to a debt in excess of $1 million is not deductible. For example, if A pays 50 percent of the interest on $1.5 million of a $3 million debt, his interest should be allocated on the basis of a fraction in which $1.5 million is the denominator rather than $3 million. If instead, A pays 100 percent of the interest on the full $3 million debt, $3 million is the correct denominator.

Although a single residence can have an aggregate amount of acquisition indebtedness, the debt may belong to different owners. Assume, for example, that A purchases a home for $1.5 million with $1 million acquisition debt. He then improves the home by adding a separate wing for his mother, financing it with a $500,000 home equity loan. When it is complete, the mother buys a 30 percent interest in the home, making a down payment and assuming the $500,000 home equity loan. The aggregate indebtedness on the property is $2 million. But A's aggregate debt is $1.5 million and his mother's is $500,000. Their individual aggregate indebtedness is not proportional to their ownership interests.

Yet another reason for reading the $1 million limit as one that applies per taxpayer is that the statute specifically applies the limit to the aggregate indebtedness ''for any period.'' The IRS has construed that language to mean that a taxpayer can deduct interest to the extent his ''average acquisition indebtedness'' does not exceed $1 million for the tax year.[20] Thus, for example, if a taxpayer borrowed $2 million exactly halfway through the tax year, the average outstanding debt for that taxpayer would be $1 million, and 100 percent of the interest could be deducted in year 1 as long as it was paid by the taxpayer. The period referred to is the taxpayer's tax year, not the period of the mortgage.

And what if partner B received his interest on December 1 of the third tax year? He is liable for $1 million of the $2 million debt under his agreement with A, but he is liable for only one month in his tax period. Surely it makes more sense to allocate aggregate acquisition indebtedness to B based on the one-month period rather than the period that the mortgage was in effect during year 3.

More recently, on the TaxProf blog, Prof. Martin McMahon challenged the construction of section 163(h)(3) as treating a husband and wife filing a joint return as a single taxpayer. He has concluded, however, that if spouses who are co-owners are limited to $1 million in acquisition indebtedness, the statute must be construed to restrict unrelated co-owners of a residence to the same $1 million limit.[21] The best way to accomplish that result is to adopt the construction supported in the legal memorandum, that is, that the limit applies to aggregate mortgages per residence rather than to the aggregate mortgage liability of an individual taxpayer. But it is difficult to apply that rule in all cases of unrelated co-owners. For example, the copurchasers may buy their interests at different times using different types of financing. Why should a person who buys into a share of living space in a residence owned by someone else and who incurs less than $1 million in acquisition debt for that purchase not be allowed to deduct 100 percent of his mortgage interest? Under the legal memorandum, he would not be able to if there was already $1 million of acquisition debt secured by the property.

Although the legislative history addressing the $1 million limitation is sparse, there are some comments in the House report that suggest Congress was envisioning a $1 million limit per taxpayer and not per residence or per mortgage. The House report said Treasury would need to promulgate regulations to explain how to allocate interest to qualified debt and to excess debt. It also said:

> In the interim until such regulations are issued, a reasonable method of allocation should be used. An example of a reasonable method of allocation is to ascertain which debt is the debt that exceeds the limitation by 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.[22]

The suggested method of allocation is reasonable only if you aggregate chronologically, taxpayer by taxpayer. If an original purchaser has exceeded the $1 million limit by borrowing to acquire his original interest in the property and then that taxpayer borrows more, the rule contemplated in the House report would correctly allocate all of the interest on the first $1 million of borrowing as qualified acquisition indebtedness. But when a subsequent purchaser incurs a subsequent liability secured by the same property to buy an undivided interest in the home, that mortgage liability should become acquisition debt for purposes of the subsequent purchaser's interest deductions.

The legal memorandum is contrary to every published piece of tax scholarship on the tax treatment of unmarried co-owners who pay interest on mortgages that exceed $1 million.[23] There is a growing body of scholarship pointing out that under current tax law, sometimes married couples win and sometimes they lose. Several tax scholars, including this author, have questioned whether those differences in tax rules make sense — either as good tax policy[24] or as constitutional legislation.[25] But none of us has ever thought the IRS could change the rules and treat married and unmarried couples the same. That would be up to Congress.

Bottom line, the IRS appears reluctant to admit that there is one tax code provision, section 163(h)(3), in which unmarried couples are given a benefit compared with married couples. When the language of the code is ambiguous, the IRS has the power to clarify. It exercised that power in the 2001 FSA by concluding that Congress must have intended to treat all married couples the same. That construction is inconsistent with the historical treatment of married taxpayers but consistent with recent changes that treat a husband and wife as one tax unit.[26] The exercise of the IRS's power is questionable, however, when the language of the code is sufficiently

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[20] *See* FSA 200137033.

[21] *See* http://taxprof.typepad.com/taxprof_blog/2009/03/mcmahon-in-defense-of-cca-200911007.html.

[22] *See* H.R. Rep. 100-391(II), P.L. 100-203 (Oct. 26, 1987).

[23] *See, e.g.,* Angela V. Langlotz, ''Tying the Knot: The Tax Consequences of Marriage,'' 54 *Tax Law*. 329 at p. 339 (2001) (making the point that a married couple's interest deduction maximum is half that of two single individuals); Shari Motro, ''A New 'I Do': Toward a Marriage Neutral Income Tax,'' 91 *Iowa L. Rev*. 1509 at p. 1551, n. 9 (2006) (same point); and Theodore P. Seto, ''The Unintended Advantages of Gay Marriage,'' 65 *Wash. & Lee L. Rev*. 1529 at p. 1571 (2008) (same point). *But see supra* note 21 for one tax professor's defense of the chief counsel advice.

[24] *See, e.g.,* William P. Kratzke, ''The Defense of Marriage Act (DOMA) is Bad Income Tax Policy,'' 35 *U. Mem. L. Rev*. 399 (2005).

[25] *See* Cain, ''DOMA and the Internal Revenue Code,'' *Chi.-Kent L. Rev.* (forthcoming 2009), available on the Social Science Research Network, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1354564 (arguing that DOMA is unconstitutional as applied to tax law).

[26] *See, e.g.,* section 2056 (the unlimited marital deduction, enacted in 1981), section 1041 (no gains or losses on interspousal property transfers, enacted in 1984), and section 121(b)(2)(A)(i)

**(Footnote continued on next page.)**

clear (as I believe it is in this case) and the construction adopted by the IRS not only is counter to that language, but also unsupported by the legislative history[27] and is inconsistent with the rest of the tax code.[28] The power to interpret is not the power to rewrite. If there is an injustice here, it is one that can be fixed only by Congress.

($500,000 nonrecognition of gain allowed on behalf of two spouses, if one spouse meets ownership requirements).

[27]The legislative history is silent on whether the $1 million limitation is to be applied at the taxpayer level, at the return level, or to the aggregate mortgage indebtedness on a single residence. But the statements in the history about how to compute the limit suggest that Congress was thinking about taxpayers or returns and not residences. *See supra* text accompanying note 22.

[28]Spouses are treated differently from unrelated individuals in at least 179 code provisions. *See* GAO/OCG 97-16, 1997 WL 67783 (F.D.C.H.) at p. 7. When Congress adopted DOMA in 1996, the explicit intent was to ensure that same-sex couples were not treated the same as spouses under any of those code sections. The effect of the chief counsel advice is to treat same-sex spouses, as well as other unmarried couples, the same as spouses.