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**TAXES**

# Tax Court Disallows Mortgage Interest Deduction

The new case involves a complex series of transactions where three brothers intermingled their business and personal interests.

Ken Berry • Mar. 10, 2023



Can you deduct mortgage interest you pay on a home you own? Recent tax legislation has tightened up the rules, but qualified borrowers may still be entitled to generous write-offs. However as shown in a new case, *Shilgevorkyan, TC Memo 2023-121, 1/23/23*, you must meet some basic requirements.

**Background:** As a general rule, an itemizer can deduct mortgage interest on an “acquisition debt” where the mortgage proceeds are used to buy, build or substantially improve a home. Typically, this is one of the biggest deductions on a personal return. To qualify for the write-off, the loan must be secured by a qualified residence, such as your principal residence or a second home like a vacation home.

Under the Tax Cuts and Jobs Act (TCJA), the interest is deductible on acquisition debt up to a \$750,000 threshold for 2018 through 2025, down from \$1 million. (The higher limit is grandfathered for prior loans.) The threshold is scheduled to revert to \$1 million in 2026.

Generally, the mortgage interest deduction is claimed by a borrower that is legally obligated to directly repay the loan. However, deductions may be permitted in certain other limited situations (e.g., recourse loans).

**Facts of the new case:** The new case involves a complex series of transactions where three brothers intermingled their business and personal interests.

In 2005, Brother A purchased a home in Paradise Valley, Arizona for \$1,525,000. Brother A made a \$392,896 down payment and, along with his wife, obtained a \$1,143,750 bank loan from Wells Fargo. In addition, the couple took out a \$1.2 million construction loan with Brother B. Both loans were secured by the Paradise Valley home.

The construction loan funds were used to build a house and a separate guest house on the property. The loans were refinanced twice with Wells Fargo. According to the terms, any transfers could not be made without Wells Fargo’s consent. Furthermore, the deed of trust stated that the Paradise Valley property would be the borrower’s principal residence for at least one year.

Brother B executed a quitclaim deed in 2010 in which he conveyed all his interest in the property to Brother C, the taxpayer claiming the deduction in the case at hand. No request was made to Wells Fargo to approve the transfer nor did Brother C pay Brother B anything.

With limited exceptions, Brother C did not claim the Paradise Valley property as his principal place of residence, although he lived in the guest house for a short period of time. On his 2012 federal income tax return, Brother C deducted \$66,354 of mortgage interest paid relating to the Paradise Valley property—half of the total mortgage interest paid in 2012 on the loan as reported by Wells Fargo. The IRS disallowed the deduction.

**Tax outcome:** The Tax Court sided with the IRS. Brother C didn't prove that the acquisition debt was his obligation, didn't show any ownership right under state law (despite the quitclaim deed) and didn't meet the requirements for a qualified residence. Case closed.

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