Committee Reports ('87 OBRA, , PL 100-203, 12/22/87)

House Explanation

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Present Law.

Under present law, the itemized deduction for personal interest is being phased out over the period 1987-90. Personal interest is any interest, other than interest incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee), investment interest, or interest taken into account in computing the taxpayer's income or loss from passive activities for the year. Personal interest also does not include interest on certain deferred estate tax. These rules are phased in and become fully effective in 1991.

Present law provides that qualified residence interest is not subject to the limitation on personal interest. Qualified residence interest is interest on debt secured by a security interest valid against a subsequent purchaser on the taxpayer's principal residence or a second residence of the taxpayer. Interest on such debt is generally deductible to the extent that the debt does not exceed the amount of the taxpayer's basis for the residence (including the cost of home improvements). Present law also allows a taxpayer to deduct as qualified residence interest the interest on certain loans incurred for educational or medical expenses up to the fair market value of the residence. A grandfather rule treats interest on debt incurred on or before August 16, 1986 and secured by the taxpayer's principal or second residence as qualified residence interest, provided the amount of the debt does not exceed the fair market value of the residence.

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Explanation of Provision.

In general.

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.

Present law with respect to qualified residence interest is continued except as otherwise modified by the bill. Thus, for example, debt giving rise to qualified residence interest under the provision means debt secured by a security interest valid against a subsequent purchaser under local law (to the same extent as under present law) on the taxpayer's principal residence or second residence (as clarified by the bill in the case of boats and mobile homes).

Acquisition indebtedness.

Acquisition indebtedness means debt that is incurred in acquiring, constructing, or substantially improving the principal or a second residence of the taxpayer. Acquisition indebtedness is reduced as payments of principal are made, and cannot be increased by refinancing. Thus, for example, if the taxpayer incurs $85,000 of acquisition indebtedness to acquire his principal residence, and pays the debt down to $60,000, his acquisition indebtedness with respect to the residence cannot thereafter be increased above $60,000 (except by indebtedness incurred to substantially improve the residence).

Under the bill, the total amount of acquisition debt that can give rise to qualified residence interest is $1 million. Thus, if the taxpayer's debt to acquire, construct or substantially improve his principal and second residence exceeds $1 million, then only the interest on a total principal amount of $1 million of such debt is deductible as acquisition interest. It is anticipated that the Internal Revenue Service will issue regulations describing the proper method for allocating interest on excess amounts of debt. 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.

In the case of married persons filing a separate return, the limit is $500,000.

Refinanced acquisition debt continues to be treated as acquisition debt to the extent that the principal amount of the refinancing does not exceed the principal amount of the acquisition debt immediately before the refinancing.

Home equity indebtedness.

Certain home equity indebtedness may also be treated as debt giving rise to deductible qualified residence interest. Home equity indebtedness, for purposes of the provision, means debt secured by the taxpayer's principal or second residence, to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

Interest on qualifying home equity indebtedness is deductible, even though the proceeds of the indebtedness are used for personal expenditures.

The amount of home equity indebtedness on which interest is treated as deductible qualified residence interest may not exceed $100,000 ($50,000 for married persons filing a separate return).

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).

Unlike present law, the bill provides no special rules for amounts borrowed for educational or medical expenditures; interest on debt incurred for such expenditures is allowed in the same manner as interest on any other home equity indebtedness under the provision.

Treatment of pre-October 13, 1987 indebtedness.

Under the bill, pre-October 13, 1987 indebtedness of the taxpayer is grandfathered. That is, it is treated as acquisition indebtedness, and the $1 million limitation does not apply to such debt. Thus, interest on such debt continues to be deductible. The amount of such debt, however, reduces the amount of the $1 million limitation on new acquisition debt (but not below zero).

Pre-October 13, 1987 debt means any debt incurred on or before October 13, 1987 and secured by a qualified residence (within the meaning of present law) on October 13, 1987 and at all times thereafter before the interest is paid or accrued. Pre-October 13, 1987 debt also includes debt secured by the qualified residence, to refinance existing pre- October 13, 1987 debt, to the extent that the principal amount of the refinancing does not exceed the principal amount of the refinanced debt immediately before the refinancing. Any refinancing may not extend the term of the debt beyond the term of the acquisition debt immediately before the refinancing. In the case of acquisition debt that is not amortized over its term (e.g., a “balloon” note), interest on any otherwise qualified refinancing will be deductible for the term of the first refinancing of such acquisition debt, but not for more than 30 years after that first refinancing.

Definition of second residence.

The bill provides that, for purposes of the deduction for qualified residence interest, mobile homes used on a transient basis and boats are not treated as a second residence of the taxpayer.

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Conference Report

The conference agreement follows the House bill except that the agreement does not contain the provision in the House bill relating to boats and mobile homes.

The conferees anticipate that Treasury regulations will be issued under section 6050H requiring reporting by mortgage interest recipients of any information necessary to enforce the limitation on qualified residence interest.

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House Explanation

Effective Date.

The provisions are effective for taxable years beginning after December 31, 1987 (with the grandfather rule described above under “treatment of pre- October 13, 1987 indebtedness”).