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The deductibility of points paid to refinance a principal residence

Thanks to a recent tax decision, taxpayers contemplating the refinancing of the mortgage on their principal home have several options available to them. Guidance is provided on refinancing strategies to achieve the greatest tax advantage.

by Janet A. Meade

During the last fifteen years, changing conditions in the mortgage market have caused many taxpayers to enter into a variety of financing arrangements other than the standard fixed-rate mortgage when purchasing a home. Subsequent changes in interest rates or lending terms, however, often have increased the desirability of refinancing the original mortgage.

One tax concern associated with the refinancing of a principal residence is the deductibility of points.[1] According to the Internal Revenue Service, points paid to refinance a home mortgage are not deductible in full in the year paid, but instead must be deducted ratably over the term of the loan.[2] The IRS's rationale for this position is that even when a new mortgage is secured by the principal residence of the taxpayer, the points paid in refinancing a home are not deductible in full in the year of payment because the loan proceeds are used to extinguish the existing home indebtedness and, hence, are not incurred in connection with the purchase or improvement of a residence.

Recently, however, the validity of the IRS's position has been challenged by the decision of the Eighth Circuit Court of Appeals in *Huntsman*.[3] In this case, the court held that points paid to refinance two short-term notes on the taxpayer's principal residence were eligible for a full deduction in the year of the borrowing because the refinancing transaction was an integrated step in the purchase of the home.

As a result of the decision in *Huntsman*, taxpayers who are contemplating a refinancing transaction now have several tax planning opportunities available to them. This article discusses these opportunities and provides guidance as to how a refinancing transaction should be structured so as to achieve the maximum tax advantage.

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The deductibility of points

It is a well-established principle that points or other similar charges paid at the time an in-

[1] A "point" is usually a fee equal to one percent of the loan amount and is paid to the lending institution to lower the interest rate. For tax purposes, the payment of points is similar to a prepayment of interest and generally is treated as being paid over the term of the loan. See H.R. Rep. No. 658, 94th Cong., 1st Sess. at 101 (1975), 1976-3 C.B. (Vol. 2) 695, 793; S. Rep. No. 938, 94th Cong., 2d Sess. at 105 (1976), 1976-3 C.B. (Vol. 3) 49, 143; Staff of Joint Comm. on Tax'n, *General Explanation of the Tax Reform Act of 1976*, 94th Cong., 2d Sess. at 102 (1976), 1976-3 C.B. (Vol. 2) 1, 114.

[2] IRS News Rel. IR-86-68 (May 13, 1986); Rev. Rul. 87-22, 1987-1 C.B. 196.

[3] James R. Huntsman, No. 89-1672 (8th Cir. 1990), *rev'g* 91 T.C. 57 (1988).

debtedness is incurred are considered interest if they represent a charge for the use or forbearance of money.[4] Accordingly, these charges are deductible under the rules regarding interest expense. Any charges for specific services, however, are not considered interest even if they are referred to as points.[5]

In general, Section 163(a) of the Internal Revenue Code allows a taxpayer a deduction for all interest paid or accrued within the tax year. Section 461(g), however, limits the actual amount of this interest deduction by providing a deduction only with respect to the amount representing compensation to a lender for the use of borrowed money during the tax year. Cash-basis taxpayers who prepay interest, therefore, are not allowed a full deduction in the year of payment, but instead must capitalize the prepaid amount and deduct it as if they were on the accrual basis.

Exception for points. An important exception to the general rule regarding the timing of prepaid interest deductions is contained in Section 461(g)(2). Under this exception, points paid at the time an indebtedness is incurred may be deducted in full in the year of payment if four criteria are met:

1. The points are paid in connection with a loan obtained to purchase or improve the taxpayer's principal residence;
2. The indebtedness is secured by the residence;
3. The payment of points is an established business practice in the area in which the loan is made; and
4. The amount of the points does not exceed the amount generally charged in the area.

If all four criteria are met, the points may be deducted in full as an interest expense in the year in which they are paid. However, the points or an amount equivalent must be actually paid by the taxpayer from his separate funds to qualify for a full deduction.[6] Amounts withheld from the loan proceeds as the equivalent of points paid may not be deducted in the year of the borrowing since, under the judicial rule established by the Tax Court in *Schubel*,[7] the withholding of points does not constitute payment of interest in the tax year.

The *Huntsman* case

In January 1981, James and Zenith Huntsman bought a principal residence. They financed the purchase of the home with a $122,000 three-year loan secured by a mortgage on the property. In July 1982, they obtained an additional loan of approximately $22,000 to finance a home improvement. This loan was secured with a second mortgage on the residence. The following year, in September 1983, they refinanced their home with a $148,000 thirty-year variable rate mortgage. The proceeds of this mortgage were used to pay off the notes secured by the existing first and second mortgages.

As part of the refinancing transaction, the Huntsmans paid points totalling $4,400. They then deducted this amount as an interest expense on their 1983 return. The IRS, however, contested their deduction arguing that, under Section 461(g), points paid in a refinancing transaction are a form of prepaid interest deductible only in the year in which the interest represents a charge for the use or forbearance of money (e.g., in this case, ratably over the life of the loan). The IRS further maintained that the exception of Section 461(g)(2) did not apply to the refinancing of the Huntsmans' home, since the new mortgage was not incurred in connection with the purchase or improvement of the residence, but rather with the extinguishment of the two short-term notes.

[4] L-R Heat Treating Co., 28 T.C. 894 (1957); Lyndell I Lay, 69 T.C. 421 (1977); Rev. Rul. 69-188, 1969-1 C.B. 5 as amended by Rev. Rul. 69-582, 1969-2 C.B. 29; Re Rul. 69-189, 1969-1 C.B. 55.

[5] Rev. Rul. 67-297, 1967-2 C.B. 87.

[6] IRS Notice 90-7, I.R.B. 1990-48 (Nov. 1990), specif that for closings occurring after December 31, 19 points will be considered as paid directly where the t payer provides funds, including down payments, escrow deposits, earnest money, and other closing funds, at least equal to the amount of the points required for application at the closing.

[7] Roger A. Schubel, 77 T.C. 701 (1981).

Tax Court decision. In a reviewed decision, the Tax Court agreed with the IRS and held that the Huntsmans were not entitled to deduct the full amount of the points in the year of the refinancing transaction. This decision was based on a narrow interpretation of Section 461(g)(2) and followed, in part, the reasoning of the earlier Tax Court decision in *Schubel*. As mentioned, in *Schubel* the court determined that the "payment" requirement of Section 461(g)(2) precluded an immediate deduction for points withheld by a lender from the proceeds of a loan because the withholding did not constitute direct payment of the points within that tax year. The court, therefore, limited the Schubels to a ratable deduction of the points over the life of the loan in accordance with the general rule of Section 461(g) regarding prepaid interest.

In *Huntsman*, the taxpayer and the IRS both agreed that the points paid in the refinancing transaction were deductible as an interest expense. At issue, therefore, was the timing of the deduction.

In addition to the decision in *Schubel*, the Tax Court in *Huntsman* also cited the legislative history of Section 461(g)(2) as justification for its narrow interpretation of the statute. Specifically, the court noted that the reports of the House, Senate, and Joint Committee each stated that a loan would not qualify under the exception of Section 461(g)(2) if the loan proceeds were used "for purposes other than purchasing or improving the taxpayer's principal residence."[8] Accordingly, the court interpreted this language as implying that Congress, when enacting the exception of Section 461(g)(2), intended to limit its application to points paid with respect to either the financing of the actual purchase of a principal residence or the financing of improvements to the residence. Based on this narrow interpretation of Section 461(g)(2), the Tax Court consequently concluded that because the indebtedness of the Huntsmans was not directly related to the original acquisition of their residence, the points paid to refinance their home were not deductible in full in the year of payment. Instead, the court held that the points were deductible ratably over the life of loan.

Appellate court decision. The Huntsmans appealed the case to the Eighth Circuit, where the decision of the Tax Court was reversed. According to the Eighth Circuit, the points paid by the Huntsmans in refinancing the two short-term notes on their home were deductible in full in the year of payment, since the refinancing transaction was an integrated step in the purchase of the home. The appellate court reached this decision on the basis of a broad interpretation of Section 461(g)(2). In particular, the court noted that Section 461(g)(2) merely requires a taxpayer's indebtedness to be "in connection with" the purchase or improvement of his principal residence and not, as the Tax Court had determined, to be "directly related to" the acquisition of the home.

Interpretative differences

In *Huntsman*, the taxpayer and the IRS both agreed that the points paid in the refinancing transaction were deductible as an interest expense. At issue, therefore, was the timing of the deduction. The Huntsmans argued that Congress intended the exception of Section 461(g)(2) to be interpreted broadly, thereby allowing a full deduction for the amount of the points in the year of the refinancing transaction. The IRS, however, claimed that the statute required a narrow interpretation in order to prevent taxpayers from using refinancing transactions to achieve other financial goals

[8] H.R. Rep. No. 658, 94th Cong., 1st Sess. at 101 (1975), 1976-3 C.B. (Vol. 2) 695, 793; S. Rep. No. 938, 94th Cong., 2d Sess. at 105 (1976), 1976-3 C.B. (Vol. 3) 49, 143; Staff of Joint Comm. on Tax'n, *General Explanation of the Tax Reform Act of 1976*, 94th Cong., 2d Sess. at 102 (1976), 1976-3 C.B. (Vol. 2) 1, 114.

not connected directly with home ownership. The IRS's position, therefore, was that the points paid by the Huntsmans were deductible only in a ratable manner over the life of the loan.

Narrow versus broad interpretation. The interpretative differences between the Huntsmans and the IRS, as well as between the Tax Court and the Eighth Circuit, centered on the language of Section 461(g)(2), which requires that a taxpayer's indebtedness be "in connection with the purchase or improvement of the taxpayer's principal residence." This language, when interpreted broadly (as by the Huntsmans and the Eighth Circuit), dictates only that the indebtedness have an "association" or "relation" with the purchase or improvement of the taxpayer's residence. In contrast, when this language is interpreted narrowly (as by the IRS and the Tax Court), the indebtedness is required to be directly related to the actual purchase or improvement of a home.

Congressional intent. Whether Congress intended the language of Section 461(g)(2) to be interpreted broadly or narrowly is a difficult question to answer. According to the Eighth Circuit, Congress adopted the phrase "in connection with" in order to widen the scope of the statute. Specifically, the appellate court noted that when Congress enacted Section 461(g)(2), it was aware of prior judicial decisions in which the phrase had been interpreted broadly, and that it consequently intended the same liberal interpretation to be given to the phrase in Section 461(g)(2).

Among the specific cases cited by the Eighth Circuit as having applied a broad interpretation to the phrase "in connection with" within a tax code setting were *Snow*,[9] *Alves*,[10] and *Rupprecht*.[11] In *Snow*, the taxpayer was a partner in a limited partnership formed for the purpose of developing a special purpose incinerator. During the 1966 tax year, the partnership made no sales, but built and tested several models of the incinerator. The IRS, Tax Court, and Sixth Circuit all disallowed the taxpayer a deduction for his distributive share of the net operating loss of the partnership on the basis that the loss was not "in connection with" a trade or business, as required under Section 174(a)(1). The Supreme Court, however, reversed these earlier court decisions and determined that the use of the phrase "in connection with" in Section 174(a)(1) was intended to dilute some of the conception of "ordinary and necessary" business expenses under Section 162(a). Accordingly, the Supreme Court held that the experimental expenditures of the partnership were "in connection with" the trade or business of the partnership even though the partnership had not been engaged in business during the year the loss was incurred.

Similarly, in both *Alves* and *Rupprecht*, the taxpayers were held to have acquired stock "in connection with" their performance of services as employees under Section 83(a). As a result, the courts determined that ordinary income treatment was mandated by the statute on their subsequent sales of the stock.

Whether Congress intended the language of Section 461(g)(2) to be interpreted broadly or narrowly is a difficult question to answer.

Statute requirements. In *Huntsman*, the Eighth Circuit decided that an equally broad interpretation of the phrase "in connection with" was applicable to the exception of Section 461(g)(2). The issue facing the court, therefore, was whether the refinancing transaction undertaken by the Huntsmans met the requirements of the statute when so interpreted. To resolve this issue, the court examined the original purchase of the Huntsmans' residence. This residence had been financed

[9] Edwin A. Snow, 416 U.S. 500 (1974), *rev'g* 482 F.2d 1029 (6th Cir. 1973), *aff'g* 58 T.C. 585 (1972).

[10] Lawrence J. Alves, 734 F.2d 478 (9th Cir. 1984), *aff'g* 79 T.C. 864 (1982).

[11] Charles F. Rupprecht, 829 F.2d 43 (Fed. Cir. 1987), *aff'g* 11 Cl. Ct. 689 (1987).

by a $122,000 short-term loan secured by a mortgage on the property. The loan was payable in monthly installments with a balloon payment required at the end of three years.

Given the terms of the Huntsmans' original financing of their home, the court determined that in economic reality the taxpayers were locked into a situation which necessitated that they obtain some form of refinancing within three years of the date of purchase. This was so regardless of changes in interest rates or the housing market. The court, moreover, believed that it was contrary to the language and intent of Section 461(g)(2) to focus on only one step in what was clearly an integrated series of connected steps in the purchase of the home. Applying a broad interpretation to the statute, therefore, the court concluded that the refinancing transaction was a foreseeable necessity "in connection with" the purchase of the home and that the points paid to refinance the residence were deductible in full in the year of payment under Section 461(g)(2).

Although the decision in *Huntsman* is a victory for the taxpayer, it fails to resolve several issues regarding the deductibility of points paid in a refinancing transaction.

Unresolved Issues

Although the decision of the Eighth Circuit in *Huntsman* is a victory for the taxpayer, it fails to resolve several issues regarding the deductibility of points paid in a refinancing transaction. Specifically, since the situation in *Huntsman* dealt only with a refinancing transaction that was necessitated by the terms of the original home loan, the court's decision does not address the deductibility of points paid to refinance a home for other purposes, such as to obtain a lower interest rate or to withdraw a portion of the taxpayer's equity in a principal residence. In addition, the decision does not consider the proper treatment of points paid to refinance a home mortgage obtained on or before October 13, 1987, under the grandfathered debt provisions of Section 163(h)(3)(D), or those incurred as a result of a refinancing transaction undertaken to purchase a former spouse's interest in a residence incident to a divorce.

Refinancing to obtain more favorable borrowing terms. In the case of a refinancing transaction undertaken to obtain a lower interest rate or more favorable borrowing terms, the timing of the deduction for points is dependent on the nature of the associated home mortgage. Section 163(h)(3)(B) provides that debt that is (1) incurred in acquiring, constructing, or substantially improving a qualified residence[12] of the taxpayer and (2) secured by the qualified residence is to be considered acquisition indebtedness. The aggregate amount of such indebtedness, however, is limited to $1 million ($500,000 in the case of a married taxpayer filing a separate return).

IRS Notice 88-74[13] further states that when a taxpayer with a mortgage classified as acquisition indebtedness incurs a second debt, the second debt will be treated as incurred to acquire, construct, or substantially improve the residence if the proceeds of the second debt are used to refinance the existing home mortgage. Consequently, under a broad interpretation of the phrase "in connection with" as used in Section 461(g)(2), any points paid to refinance an existing mortgage on a taxpayer's principal residence originally classified as acquisition indebtedness presumably would be deductible in full in the year paid, regardless of the motive for the refinancing, since the points would be incurred in connection with the purchase or improvement of the taxpayer's home.

Refinancing to withdraw equity. A different tax treatment is required, however, when a

[12] Under I.R.C. Section 163(h)(4), the term "qualified residence" means the principal and secondary residences of the taxpayer.

[13] IRS Notice 88-74, 1988-2 C.B. 385.

taxpayer uses a refinancing transaction to withdraw a portion of the equity in his principal residence. In this case, the points paid to obtain the second debt would be only partially deductible in the year of payment, since that part of the second debt exceeding the original home mortgage would not be considered acquisition indebtedness, and, hence, would not fall under the exception of Section 461(g)(2). Instead, only the portion of the points incurred with respect to the refinancing of the original mortgage would be fully deductible in the year of payment; the balance would be deductible ratably over the life of the loan.

Both of the preceding analyses are based on an assumption that the original home mortgage of the taxpayer was incurred after October 13, 1987. When a taxpayer refinances a home mortgage that was incurred on or before this date, the analyses differ somewhat. The deductibility of points paid for the refinancing transaction, however, remains much the same.

Refinancing of grandfathered debt. Under the grandfathered debt provisions of Section 163(h)(3)(D), any debt secured by a qualified residence that was incurred on or before October 13, 1987, is classified as acquisition indebtedness, irrespective of the dollar amount. In addition, any debt secured by the qualified residence that was incurred after October 13, 1987, to refinance an original home mortgage incurred on or before October 13, 1987, is considered acquisition indebtedness to the extent that the principal amount of the debt does not exceed the principal amount of the original home mortgage.

When Section 163(h)(3)(D) is interpreted in light of the exception of Section 461(g)(2), it can be seen that points paid with respect to refinancing transactions involving grandfathered debt incurred on or before October 13, 1987, are deductible in the same manner as points paid to refinance debt incurred after this date, except that the amount of the original home mortgage that may be classified as acquisition indebtedness is unlimited. Accordingly, as long as the principal amount of the new debt does not exceed the principal amount of the refinanced debt, a full deduction would be allowed in the year the points are paid. If the new debt exceeds the refinanced debt, however, only that portion of the points paid to refinance the original debt would be deductible in full in the year of payment. The portion of the points associated with the new debt in excess of the refinanced debt would be deductible in a ratable manner over the life of the loan.

Refinancing incident to a divorce. One additional situation in which a refinancing transaction may be undertaken is when a taxpayer wishes to purchase a former spouse's interest in a residence as a result of a divorce. Under Section 1041, no gain or loss is recognized on

Accordingly, as long as the principal amount of the new debt does not exceed the principal amount of the refinanced debt, a full deduction would be allowed in the year the points are paid.

the transfer of property between spouses, even if the transferred property is sold at its fair market value. Moreover, property transferred incident to a divorce is treated as having been acquired by the transferee spouse by gift. Absent any other legislative or administrative authority, therefore, Section 1041 would appear to preclude a deduction for the full amount of points paid with respect to the refinancing of a home mortgage incident to a divorce, since the residence would be deemed to be acquired by gift and would not, as required by Section 461(g)(2), be incurred in connection with the purchase or improvement of the home.

Relief from this result, however, is provided by IRS Notice 88-74. As specified in this notice, debt incurred to acquire the interest of a former spouse in a residence incident to a divorce may be treated as debt incurred in acquiring a residence, without regard to the treatment of the transaction under Section 1041.[14] Accordingly, the portion of the points associated with that part of the mortgage incurred to purchase the former spouse's interest in a residence would be fully deductible when paid. Likewise, the balance of the points associated with the remaining portion of the mortgage used to refinance the taxpayer's share of the original home indebtedness also would be fully deductible in the year of payments since, as discussed above, the principal amount of this part of the mortgage would not exceed the principal amount of the original home indebtedness. The combined effect of such a refinancing transaction, therefore, would be to allow the taxpayer a deduction in the year of payment for the full amount of the points paid with respect to the purchase of the former spouse's interest in the residence.

A different tax treatment is required, however, when a taxpayer uses a refinancing transaction to withdraw a portion of the equity in his principal residence.

Other refinancing transactions. Because the decision in *Huntsman* does not apply to the deductibility of points paid to refinance a mortgage other than one secured by the principal residence of the taxpayer, this article has not dealt with such refinancing transactions directly. However, should a taxpayer decide to undertake such a transaction, the deduction for any points paid would be governed by the general rules regarding prepaid interest. These rules, as specified by Sections 163(a) and 461(g), require cash-basis taxpayers who prepay interest in the form of points or other charges to capitalize the amount of the prepayment and deduct it as if they were on the accrual basis over the life of the loan.

Reporting of points

Under pre-1989 law, Section 6050H required an information return to be filed by any person who in the course of a trade or business received from an individual $600 or more of interest during a calendar year on an obligation secured by real property. Regulation Section 1.6050H-1(e), however, provided that points paid with respect to mortgages were not to be treated as interest for purposes of this reporting requirement.

Beginning in 1992, a new requirement will apply to the reporting of points.[15] Under this requirement, a bank or other lender will be required to include on the information return the amount of points incurred to obtain the mortgage and whether the payment of the points are made by the borrower directly or withheld from the loan proceeds. As discussed in this article, the deduction for points that are withheld from the loan proceeds is limited to a ratable amount over the life of the loan. The deduction for points that are paid by the borrower directly, however, may be the full amount of the payment if the four requirements of Section 461(g)(2) are met. Moreover, under IRS Notice 90-7,[16] the payment of points for closings occurring after December 31, 1990, will be considered direct where the taxpayer provides down payments, escrow deposits, earnest money, or other closing funds at least equal to the points required for application of the closing.

Conclusion

Although the IRS's position is that points paid to refinance a mortgage on a principal residence are deductible ratably over the life of

[14] IRS Notice 88-74, *supra* note 13, also specifies that these rules apply to the purchase of a spouse's interest in a residence incident to a legal separation.

[15] Act § 7646 of the Revenue Reconciliation Act of 1989, amending I.R.C. §§ 6050H(b) and 6050H(d)(2).

[16] IRS Notice 90-7, *supra* note 6.

the loan, the recent decision of the Eighth Circuit in *Huntsman* indicates that under certain circumstances, such points will be deductible in full in the year of payment. Specifically, the decision in *Huntsman* makes it clear that points paid for a refinancing transaction that is necessitated by the terms of the original home mortgage will qualify for the exception of Section 461(g)(2) and be fully deductible when paid. Recent changes to the Code in Section 163(h)(3), together with the guidance provided by IRS Notice 88-74, also imply that points paid with respect to many additional types of refinancing transactions may qualify for a full deduction in the year of payment. Taxpayers who are contemplating refinancing their principal residences, therefore, are more likely to find the economics of such transactions to be positive. Appropriate tax advice, nevertheless, is still needed before any such refinancing transaction is undertaken in order to assure that the desired outcome is achieved. ■