

## **TD 8168 (12/22/1987) – Personal Interest and Home Mortgage Interest Expense Regulations - §1.163-9T and §1.163-10T**

### **AGENCY:**

Internal Revenue Service, Treasury.

### **ACTION:**

Temporary regulations.

### **SUMMARY:**

This document contains temporary regulations relating to the treatment of personal interest and the treatment and determination of qualified residence interest. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations for the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the Federal Register. Changes to the applicable tax law were made by the Tax Reform Act of 1986. The regulations affect taxpayers other than corporations who have paid or accrued personal interest during a taxable year, and taxpayers who have paid or accrued interest on debt secured by a principal or second residence.

### **DATES:**

The regulations are effective for taxable years beginning after December 31, 1986.

### **FOR FURTHER INFORMATION CONTACT:**

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### **SUPPLEMENTARY INFORMATION:**

#### **Background**

This document amends the Income Tax Regulations (26 CFR Part 1) and the Table of OMB Control Numbers (26 CFR Part 602) to provide rules under section 163(h) of the Internal Revenue Code of 1986. Section 163(h) was added to the Code by section 511(b) of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2246).

#### **Explanation of Statutory Provisions**

Section 163(h)(1) provides that in the case of a taxpayer other than a corporation, no deduction shall be allowed under Chapter 1 of the Internal

Revenue Code for personal interest paid or accrued during the taxable year. Section 163(h)(2) defines personal interest as any interest otherwise allowable as a deduction under Chapter 1 of the Internal Revenue Code other than (a) interest paid or accrued on indebtedness properly allocable to the conduct of a trade or business (other than the trade or business of performing services as an employee), (b) investment interest, (c) interest taken into account under section 469 in computing income or loss from a passive activity, (d) qualified residence interest, or (e) interest payable under section 6601 on any unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163, 6166 or 6166A (as in effect before its repeal by the Economic Recovery Tax Act of 1981).

Section 163(h)(3) defines qualified residence interest as interest paid or accrued on debt that is secured by a qualified residence at the time such interest is paid or accrued. Under section 163(h)(3)(B), however, interest expense constitutes qualified residence interest only to the extent that the underlying debt, when added to the principal balance of all other debt previously secured by the qualified residence, does not exceed the lesser of (a) the fair market value of the qualified residence, or (b) the sum of the taxpayer's basis in the qualified residence (adjusted only by the cost of any improvements) plus the amount of qualified indebtedness (secured medical and educational debt). Section 163(h)(3)(C) provides that for purposes of this limitation the taxpayer's basis in the qualified residence shall not be less than the principal balance of debt incurred prior to August 16, 1986, and secured by the qualified residence on August 16, 1986. Section 163(h)(3)(D) provides that, except as provided in regulations, any determination with respect to the limitation on the amount of qualified residence interest shall be made at the time the debt is incurred.

Qualified indebtedness is defined in section 163(h)(4) as debt secured by a qualified residence which is incurred after August 16, 1986, to pay for certain medical and educational

expenses, which are paid or incurred within a reasonable period of time before or after such debt is incurred.

Section 163(h)(5) defines qualified residence as the principal residence of the taxpayer and one other residence designated by the taxpayer.

#### Explanation of Regulatory Provisions

The regulations adopt an annual test to determine whether a taxpayer's debt secured by a qualified residence ("secured debt") exceeds the section 163(h)(3)(B) limitation on qualified residence interest. An annual approach was chosen rather than a test applied only at the time a debt is incurred because an annual approach takes account of reductions in the principal balance of secured debt and, therefore, removes the incentive to refinance a secured debt in order to redetermine the limitation. Moreover, an annual test accounts more appropriately for lines of credit, the balance of which may fluctuate from year to year.

The regulations apply the annual test by comparing the section 163(h)(3)(B) limitation with the average principal balance of the debt during the taxable year. The average balance was selected over the principal balance of the debt on a particular day during the year (such as the first day of the year or the day on which the principal balance is the highest) because the average balance more accurately reflects the amount of debt outstanding over the course of the year and is more closely associated with the amount of interest paid.

Under the regulations, a taxpayer's basis in a residence (the "adjusted purchase price") is determined as of the end of each year, instead of at the time a debt is incurred. By providing for determination of the adjusted purchase price at the end of each year, the regulations permit a taxpayer to apply a single overall limitation to all secured debts, rather than a separate limitation for each debt. In addition, the use of an end-of-year adjusted purchase price permits taxpayers to take advantage of increases in the adjusted purchase price due to home improvements without the need to refinance debt.

In contrast, however, the regulations generally require the fair market value of the residence to be determined as of the time a debt is incurred.

Limiting the fair market value determination to the date a debt is incurred will minimize controversy between taxpayers and the Service because the residence's fair market value with respect to any particular debt will be determined only once and because an independent appraisal ordinarily is conducted in connection with arm's length lending transactions.

In the case of a qualified residence that is real property, the regulations provide an irrebuttable presumption that the fair market value is no less than the adjusted purchase price of the residence as of the end of the current taxable year. This presumption further reduces controversy between taxpayers and the Service over fair market value. It is believed that, in a broad range of circumstances, fair market value will in fact be at least as great as the adjusted purchase price.

These simplifications permit a taxpayer to determine whether all interest expense on secured debt is qualified residence interest by comparing the sum of the average balances for the taxable year of all secured debt to the adjusted purchase price determined as of the end of the year. If this sum is less than the adjusted purchase price, all of the interest paid or accrued on the secured debt is qualified residence interest. If the combined average balance exceeds the adjusted purchase price, the taxpayer must determine the amount of qualified residence interest using either the "simplified method" or the "exact method." (A taxpayer may use a different method for each qualified residence in each taxable year.)

Under the simplified method, the amount of qualified residence interest is determined by multiplying the total interest paid or accrued on all of the debt secured by a qualified residence by a fraction, the numerator of which is the adjusted purchase price and the denominator of which is the combined average balance. Any disallowed interest is treated as personal interest, the deduction for which is phased out over the period 1987 through 1990.

If a taxpayer wishes to take advantage of qualified indebtedness (secured medical and educational debt) or wishes to trace interest expense on secured debt to expenditures other than personal expenditures, the taxpayer must use the exact method. Under the exact method,

the amount of qualified residence interest is determined on a debt-by-debt basis by comparing each debt to the applicable debt limit determined for that debt. If the average balance for any debt is less than its applicable debt limit, all of the interest paid or accrued on that debt is qualified residence interest. If the average balance exceeds its applicable debt limit, only a portion of the interest on the debt is qualified residence interest. The treatment of the remaining interest on the debt is determined by the use of the proceeds of the debt. If, for example, the proceeds of the debt were used to purchase investment assets, the remaining interest is investment interest subject to section 163 (d).

The applicable debt limit for any debt is determined in two steps. First, the taxpayer determines the lesser of (a) the fair market value of the residence at the time the debt was secured, and (b) the sum of the adjusted purchase price (determined as of the end of the taxable year) plus the amount of qualified indebtedness for that debt and for all previously secured debt. Second, the taxpayer subtracts the average balance (or, if less, the applicable debt limit) of all previously secured debts from the amount so determined.

The regulations provide guidance on the determination of the amount of qualified indebtedness (i.e., the amount of debt used to pay for qualified medical and educational expenses). If at least 90 percent of the proceeds of a secured debt are used to pay for qualified medical and educational expenses, the amount of qualified medical and educational expenses, the amount of qualified indebtedness is the average balance of the debt. If less than 90 percent of the proceeds of a secured debt are used to pay for such expenses, the amount of qualified indebtedness is the lesser of the average balance of the debt or the amount used to pay such expenses, reduced by principal payments on the debt in prior taxable years. The regulations provide rules for determining whether proceeds of a debt are used to pay for qualified medical or educational expenses. In general, a taxpayer may treat proceeds as being so used if medical or educational expenditures are made within 90 days before or after the date a debt is incurred. A taxpayer may also treat proceeds as being used to pay for such expenditures if the debt is

traceable to such expenditures under the tracing rules provided in §1.163-8T.

The regulations also provide guidance regarding the determination of the aggregate outstanding principal amount of debt which was incurred on or before August 16, 1986 and secured by the qualified residence before August 16, 1986, (i.e., the amount of grandfathered debt). In general, in any year, the grandfathered amount of such debt is the average balance of the debt during the taxable year. The regulations also permit a debt incurred to refinance a grandfathered debt to itself be treated as a grandfathered debt. In cases where the taxpayer has borrowed new amounts after August 16, 1986, on a grandfathered debt or refinanced a grandfathered debt with a larger debt, the regulations provide appropriate limits on the grandfathered amount.

The regulations require that in order to be considered secured by a qualified residence, a debt must be secured by an instrument that makes the interest of the debtor in the qualified residence specific security for the payment of the debt and that is recorded in accordance with applicable State law. The regulations provide that a debt will be considered to be secured notwithstanding the fact that under an applicable State or local homestead law or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted. This provision, which is consistent with provisions contained in pending technical corrections legislation, is intended to allow the benefit of the mortgage interest deduction despite state law impediments to securing mortgage debt. A taxpayer may elect to treat a debt that is secured by a qualified residence as if it were not secured by the residence.

The regulations provide guidance regarding the definition of a residence for purposes of section 163(h). They provide generally that a residence includes a house, condominium, cooperative, mobile home, boat or similar property which provides basic living accommodations, including sleeping space and toilet and cooking facilities. Additionally, if a portion of a residence is not used for residential purposes (e.g., a room used as a home office), that portion does not qualify as a residence. In such cases, the taxpayer must allocate the fair market value and basis in the property (but not the average balance or interest

on the debt) between the portion of the property used as a residence and the portion not so used.

#### Special Analyses

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis therefore is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The collection of information requirements contained in this regulation have been approved by the Office of Management and Budget (OMB) under section 3507 of the Paperwork Reduction Act.

#### Drafting Information

The principal author of these regulations is Sharon L. Hall of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, on matters of both substance and style.

#### List of Subjects

26 CR 1.61-1-1.281-4

Income taxes, Taxable income, Deductions, Exemptions.

26 CFR Part 602

Reporting and recordkeeping requirements.

#### Amendments to the Regulations

For the reasons set out in the preamble, Title 26, Chapter 1, Subchapter A, Part 1 and Part 602 of the Code of Federal Regulations is amended as set forth below.

#### PART 1-[AMENDED]

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority:

26 U.S.C. 7805. Section 1.163-9T also issued under 26 U.S.C. 163 (h) (3) (D).

Par. 2. The following new §§1.163-9T and 1.163-10T are added immediately after §1.163-8T.

§1.163-9T Personal interest (temporary).

(a) In general. No deduction under any provision of Chapter 1 of the Internal Revenue Code shall be allowed for personal interest paid or accrued during the taxable year by a taxpayer other than a corporation.

(b) Personal interest-(1) Definition. For purposes of this section, personal interest is any interest expense other than-

(i) Interest paid or accrued on indebtedness properly allocable (within the meaning of §1.163-8T) to the conduct of trade or business (other than the trade or business of performing services as an employee),

(ii) Any investment interest (within the meaning of section 163(d)(3)),

(iii) Any interest that is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer,

(iv) Any qualified residence interest (within the meaning of section 163(h)(3) and §1.163-10T), and

(v) Any interest payable under section 6601 with respect to the unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163, 6166, or 6166A (as in effect before its repeal by the Economic Recovery Tax Act of 1981).

(2) Interest relating to taxes-(i) In general. Except as provided in paragraph (b)(2)(iii) of this section, personal interest includes interest-

(A) Paid on underpayments of individual Federal, State or local income taxes and on indebtedness used to pay such taxes (within the meaning of §1.168-8T), regardless of the source of the income generating the tax liability;

(B) Paid under section 453(e)(4)(B) (interest on deferred tax resulting from certain installment sales) and section 1291(c) (interest on deferred tax attributable to passive foreign investment companies); or

(C) Paid by a trust, S corporation, or other pass-through entity on underpayments of State or

local income taxes and on indebtedness used to pay such taxes.

(ii) Example. A, an individual, owns stock of an S corporation. On its return for 1987, the corporation underreports its taxable income. Consequently, A underreports A's share of that income on A's tax return. In 1989, A pays the resulting deficiency plus interest to the Internal Revenue Service. The interest paid by A in 1989 on the tax deficiency is personal interest, notwithstanding the fact that the additional tax liability may have arisen out of income from a trade or business. The result would be the same if A's business had been operated as a sole proprietorship.

(iii) Certain other taxes. Personal interest does not include interest-

(A) Paid with respect to sales, excise and similar taxes that are incurred in connection with a trade or business or an investment activity;

(B) Paid by an S corporation with respect to an underpayment of income tax from a year in which the S corporation was a C corporation or with respect to an underpayment of the taxes imposed by sections 1374 or 1375, or similar provision of State law; or

(C) Paid by a transferee under section 6901 (tax liability resulting from transferred assets), or a similar provision of State law, with respect to a C corporation's underpayment of income tax.

(3) Cross references. See §1.163-8T for rules for determining the allocation of interest expense to various activities. See §1.163-10T for rules concerning qualified residence interest.

(C) Effective date-(1) In general. The provisions of this section are effective for taxable years beginning after December 31, 1986. In the case of any taxable year beginning in calendar years 1987 through 1990, the amount of personal interest that is nondeductible under this section is limited to the applicable percentage of such amount.

(2) Applicable percentages. The applicable percentage for taxable years beginning in 1987 through 1990 are as follows: 1987: 35 percent 1988: 60 percent 1989: 80 percent 1990: 90 percent

§1.163-10T Qualified residence interest (temporary).

(a) Table of contents. This paragraph (a) lists the major paragraphs that appear in this section 1.163-10T. (a) Table of contents. (b) Treatment of qualified residence interest. (c) Determination of qualified residence interest when secured debt does not exceed the adjusted purchase price. (1) In general. (2) Examples. (d) Determination of qualified residence interest when secured debt exceeds adjusted purchase price-Simplified method. (1) In general. (2) Treatment of interest paid or accrued on secured debt that is not qualified residence interest. (3) Example. (e) Determination of qualified residence interest when secured debt exceeds adjusted purchase price-Exact method. (1) In general. (2) Determination of applicable debt limit. (3) Example. (4) Treatment of interest paid or accrued with respect to secured debt that is not qualified residence interest. (i) In general. (ii) Example. (iii) Special rule of debt is allocated to more than one expenditure. (iv) Example. (f) Special rules. (1) Special rules for personal property. (i) In general. (ii) Example. (2) Special rule for real property. (i) In general. (ii) Example. (g) Selection of method. (h) Average balance. (1) Average balance defined. (2) Average balance reported by lender. (3) Average balance computed on a daily basis. (i) In general. (ii) Example. (4) Average balance computed using the interest rate. (i) In general. (ii) Points and prepaid interest. (iii) Examples. (5) Average balance computed using average of beginning and ending balance. (i) In general. (ii) Example. (6) Highest principal balance. (7) Other methods provided by the Commissioner. (8) Anti-abuse rule. (i) [Reserved.] (j) Determination of interest paid or accrued during the taxable year. (1) In general. (2) Special rules for cash-basis taxpayers. (i) Points deductible in year paid under section 461(g)(2). (ii) Points and other prepaid interest described in section 461(g) (1). (3) Examples. (k) Determination of adjusted purchase price and fair market value. (1) Adjusted purchase price. (i) In general. (ii) Adjusted purchase price of a qualified residence acquired incident to divorce. (iii) Examples. (2) Fair market value. (i) In general. (ii) Examples. (3) Allocation of adjusted purchase price and fair market value. (l) [Reserved.] (m) Grandfathered amount. (1) Substitution for adjusted purchase price. (2) Determination of grandfathered amount. (i) In general. (ii) Special rule for lines of credit and certain other debt.

(iii) Fair market value limitation. (iv) Examples. (3) Refinancing of grandfathered debt. (i) In general. (ii) Determination of grandfathered amount. (4) Limitation on terms of grandfathered debt. (i) In general. (ii) Special rule for nonamortizing debt. (iii) Example. (n) Qualified indebtedness (secured debt used for medical and educational purposes). (1) In general. (i) Treatment of qualified indebtedness. (ii) Determination of amount of qualified indebtedness. (iii) Determination of amount of qualified indebtedness for mixed-use debt. (iv) Example. (v) Prevention of double counting in year of refinancing. (vi) Special rule for principal payments in excess of qualified expenses. (2) Debt used to pay for qualified medical or educational expenses. (i) In general. (ii) Special rule for refinancing. (iii) Other special rules. (iv) Examples. (3) Qualified medical expenses. (4) Qualified educational expenses. (o) Secured debt. (1) In general. (2) Special rule for debt in certain States. (3) Time at which debt is treated as secured. (4) Partially secured debt. (i) In general. (ii) Example. (5) Election to treat debt as not secured by a qualified residence. (i) In general. (ii) Example. (iii) Allocation of debt secured by two qualified residences. (p) Definition of qualified residence. (1) In general. (2) Principal residence. (3) Second residence. (i) In general. (ii) Definition of residence. (iii) Use as a residence. (iv) Election of second residence. (4) Allocations between residence and other property. (i) In general. (ii) Special rule for rental of residence. (iii) Examples. (5) Residence under construction. (i) In general. (ii) Example. (6) Special rule for the time-sharing arrangements. (q) Special rules for tenant-stockholders in cooperative housing corporations. (1) In general. (2) Special rule where stock may not be used to secure debt. (3) Treatment of interest expense of the cooperative described in section 216(a)(2). (4) Special rule to prevent tax avoidance. (5) Other definitions. (r) Effective date.

(b) Treatment of qualified residence interest. Except as provided below, qualified residence interest is deductible under section 163(a). Qualified residence interest is not subject to limitation or otherwise taken into account under section 163(d) (limitation on investment interest), section 163(h)(1) (disallowance of deduction for personal interest), section 263A (capitalization and inclusion in inventory costs

of certain expenses) or section 469 (limitations on losses from passive activities). Qualified residence interest is subject to the limitation imposed by section 263(g) (certain interest in the case of straddles), section 264(a) (2) and (4) (interest paid in connection with certain insurance), section 265(a)(2) (interest relating to tax-exempt income), section 266 (carrying charges), section 267(a)(2) (interest with respect to transactions between related taxpayers) section 465 (deductions limited to amount at risk), section 1277 (deferral of interest deduction allocable to accrued market discount), and section 1282 (deferral of interest deduction allocable to accrued discount).

(c) Determination of qualified residence interest when secured debt does not exceed adjusted purchase price—(1) In general. If the sum of the average balances for the taxable year of all secured debts on a qualified residence does not exceed the adjusted purchase price (determined as of the end of the taxable year) of the qualified residence, all of the interest paid or accrued during the taxable year with respect to the secured debts is qualified residence interest. If the sum of the average balances for the taxable year of all secured debts exceeds the adjusted purchase price of the qualified residences (determined as of the end of the taxable year), the taxpayer must use either the simplified method (see paragraph (d) of this section) or the exact method (see paragraph (e) of this section) to determine the amount of interest that is qualified residence interest.

(2) Examples.

Example (1). T purchases a qualified residence in 1987 for \$65,000. T pays \$6,500 in cash and finances the remainder of the purchase with a mortgage of \$58,500. In 1988, the average balance of the mortgage is \$58,000. Because the average balance of the mortgage is less than the adjusted purchase price of the residence (\$65,000), all of the interest paid or accrued during 1988 on the mortgage is qualified residence interest.

Example (2). The facts are the same as in example (1), except that T incurs a second mortgage on January 1, 1988, with an initial principal balance of \$2,000. The average balance of the second mortgage in 1988 is \$1,900. Because the sum of the average balance

of the first and second mortgages (\$59,900) is less than the adjusted purchase price of the residence (\$65,000), all of the interest paid or accrued during 1988 on both the first and second mortgages is qualified residence interest.

Example (3). P borrows \$50,000 on January 1, 1988 and secures the debt by a qualified residence. P pays the interest on the debt monthly, but makes no principal payments in 1988. There are no other debts secured by the residence during 1988. On December 31, 1988, the adjusted purchase price of the residence is \$40,000. The average balance of the debt in 1988 is \$50,000. Because the average balance of the debt exceeds the adjusted purchase price (\$10,000), some of the interest on the debt is not qualified residence interest. The portion of the total interest that is qualified residence interest must be determined in accordance with the rules of paragraph (d) or paragraph (e) of this section.

(d) Determination of qualified residence interest when secured debt exceeds adjusted purchase price-Simplified method-(1) In general. Under the simplified method, the amount of qualified residence interest for the taxable year is equal to the total interest paid or accrued during the taxable year with respect to all secured debts multiplied by a fraction (not in excess of one), the numerator of which is the adjusted purchase price (determined as of the end of the taxable year) of the qualified residence and the denominator of which is the sum of the average balances of all secured debts.

(2) Treatment of interest paid or accrued on secured debt that is not qualified residence interest. Under the simplified method, the excess of the total interest paid or accrued during the taxable year with respect to all secured debts over the amount of qualified residence interest is personal interest.

(3) Example. R's principal residence has an adjusted purchase price on December 31, 1988, of \$105,000. R has two debts secured by the residence, with the following average balances and interest payments:

Debt	Date secured	Average balance	Interest
Debt 1	June 1983	\$80,000	\$8,000
Debt 2	May 1987	40,000	4,800
Total		120,000	12,800

The amount of qualified residence interest is determined under the simplified method by multiplying the total interest (\$12,800) by a fraction (expressed as a decimal amount) equal to the adjusted purchase price (\$105,000) of the residence divided by the combined average balances (\$120,000). For 1988, this fraction is equal to 0.875 (\$105,000/\$120,000). Therefore, \$11,200 (\$12,800×0.875) of the total interest is qualified residence interest. The remaining \$1,600 in interest (\$12,800-\$11,200) is personal interest, even if (under the rules of §1.163-8T) such remaining interest would be allocated to some other category of interest.

(e) Determination of qualified residence interest when secured debt exceeds adjusted purchase price-Exact method-(1) In general. Under the exact method, the amount of qualified residence interest for the taxable year is determined on a debt-by-debt basis by computing the applicable debt limit for each secured debt and comparing each such applicable debt limit to the average balance of the corresponding debt. If, for the taxable year, the average balance of a secured debt does not exceed the applicable debt limit for that debt, all of the interest paid or accrued during the taxable year with respect to the debt is qualified residence interest. If the average balance of the secured debt exceeds the applicable debt limit for that debt, the amount of qualified residence interest with respect to the debt is determined by multiplying the interest paid or accrued with respect to the debt by a fraction, the numerator of which is the applicable debt limit for that debt and the denominator of which is the average balance of the debt.

(2) Determination of applicable debt limit. For each secured debt, the applicable debt limit for the taxable year is equal to

(i) The lesser of-

(A) The fair market value of the qualified residence as of the date the debt is first secured, and

(B) The adjusted purchase price of the qualified residence as of the end of the taxable year,

(ii) Reduced by the average balance of each debt previously secured by the qualified residence.

For purposes of paragraph (e)(2)(ii) of this section, the average balance of a debt shall be

treated as not exceeding the applicable debt limit of such debt. See paragraph (n)(1)(i) of this section for the rule that increases the adjusted purchase price in paragraph (e)(2)(i)(B) of this section by the amount of any qualified indebtedness (certain medical and educational debt). See paragraph (f) of this section for special rules relating to the determination of the fair market value of the qualified residence.

(3) Example. (i) R's principal residence has an adjusted purchase price on December 31, 1988, of \$105,000. R has two debts secured by the residence. The average balances and interest payments on each debt during 1988 and fair market value of the residence on the date each debt was secured are as follows:

Debt	Date secured	Fair market value	Average balance	Interest
Debt 1 .....	June 1983 .....	\$100,000	\$80,000	\$8,000
Debt 2 .....	May 1987 .....	140,000	40,000	4,800
Total .....			120,000	12,800

(ii) The amount of qualified residence interest for 1988 under the exact method is determined as follows. Because there are no debts previously secured by the residence, the applicable debt limit for Debt 1 is \$100,000 (the lesser of the adjusted purchase price as of the end of the taxable year and the fair market value of the residence at the time the debt was secured). Because the average balance of Debt 1 (\$80,000) does not exceed its applicable debt limit (\$100,000), all of the interest paid on the debt during 1988 (\$8,000) is qualified residence interest.

(iii) The applicable debt limit for Debt 2 is \$25,000 (\$105,000 (the lesser of \$140,000 fair market value and \$105,000 adjusted purchase price) reduced by \$80,000 (the average balance of Debt 1)). Because the average balance of Debt 2 (\$40,000) exceeds its applicable debt limit, the amount of qualified residence interest on Debt 2 is determined by multiplying the amount of interest paid on the debt during the year (\$4,800) by a fraction equal to its applicable debt limit divided by its average balance ( $\$25,000/\$40,000=0.625$ ). Accordingly, \$3,000 ( $\$4,800 \times 0.625$ ) of the interest paid in 1988 on Debt 2 is qualified residence interest.

The character of the remaining \$1,800 of interest paid on Debt 2 is determined under the rules of paragraph (e)(4) of this section.

(4) Treatment of interest paid or accrued with respect to secured debt that is not qualified residence interest-(i) In general. Under the exact method, the excess of the interest paid or accrued during the taxable year with respect to a secured debt over the amount of qualified residence interest with respect to the debt is allocated under the rules of §1.163-8T.

(ii) Example. T borrows \$20,000 and the entire proceeds of the debt are disbursed by the lender to T's broker to purchase securities held for investment. T secures the debt with T's principal residence. In 1990, T pays \$2,000 of interest on the debt. Assume that under the rules of paragraph (e) of this section, \$1,500 of the interest is qualified residence interest. The remaining \$500 in interest expense would be allocated under the rules of §1.163-8T. Section 1.163-8T generally allocates debt (and the associated interest expense) by tracing disbursements of the debt proceeds to specific expenditures. Accordingly, the \$500 interest expense on the debt that is not qualified residence interest is investment interest subject to section 163(d).

(iii) Special rule if debt is allocated to more than one expenditure. If-

(A) The average balance of a secured debt exceeds the applicable debt limit for that debt, and

(B) Under the rules of §1.163-8T, interest paid or accrued with respect to such debt is allocated to more than one expenditure,

the interest expense that is not qualified residence interest may be allocated among such expenditures, to the extent of such expenditures, in any manner selected by the taxpayer.

(iv) Example. (i) C borrows \$60,000 secured by a qualified residence. C uses (within the meaning of §1.163-8T) \$20,000 of the proceeds in C's trade or business, \$20,000 to purchase stock held for investment and \$20,000 for personal purposes. In 1990, C pays \$6,000 in interest on the debt and, under the rules of §1.163-8T, \$2,000 in interest is allocable to trade or business expenses, \$2,000 to investment expenses and \$2,000 to personal expenses.



Assume that under paragraph (e) of this section, \$2,500 of the interest is qualified residence interest and \$3,500 of the interest is not qualified residence interest.

(ii) Under paragraph (e)(4)(iii) of this section, C may allocate up to \$2,000 of the interest that is not qualified residence interest to any of the three categories of expenditures up to a total of \$3,500 for all three categories. Therefore, for example, C may allocate \$2,000 of such interest to C's trade or business and \$1,500 of such interest to the purchase of stock.

(f) Special rules-(1) Special rules for personal property-(i) In general. If a qualified residence is personal property under State law (e.g., a boat or motorized vehicle)-

(A) For purposes of paragraphs (c)(1) and (d)(1) of this section, if the fair market value of the residence as of the date that any secured debt (outstanding during the taxable year) is first secured by the residence is less than the adjusted purchase price as of the end of the taxable year, the lowest such fair market value shall be substituted for the adjusted purchase price.

(B) For purposes of paragraphs (e)(2)(i)(A) and (f)(1)(i)(A) of this section, the fair market value of the residence as of the date the debt is first secured by the residence shall not exceed the fair market value as of any date on which the taxpayer borrows any additional amount with respect to the debt.

(ii) Example. D owns a recreational vehicle that is a qualified residence under paragraph (p)(4) of this section. The adjusted purchase price and fair market value of the recreational vehicle is \$20,000 in 1989. In 1989, D establishes a line of credit secured by the recreational vehicle. As of June 1, 1992, the fair market value of the vehicle has decreased to \$10,000. On that day, D borrows an additional amount on the debt by using the line of credit. Although under paragraphs (e)(2)(i) and (f)(1)(i)(A) of this section, fair market value is determined at the time the debt is first secured, under paragraph (f)(1)(i)(B) of this section, the fair market value is the lesser of that amount or the fair market value on the most recent date that D borrows any additional amount with respect to the line of credit. Therefore, the fair market value with respect to the debt is \$10,000.

(2) Special rule for real property-(i) In general. For purposes of paragraph (e)(2)(i)(A) of this section, the fair market value of a qualified residence that is real property under State law is presumed irrebuttably to be not less than the adjusted purchase price of the residence as of the last day of the taxable year.

(ii) Example. (i) C purchases a residence on August 11, 1987, for \$50,000, incurring a first mortgage. The residence is real property under State law. During 1987, C makes \$10,000 in home improvements. Accordingly, the adjusted purchase price of the residence as of December 31, 1988, is \$60,000. C incurs a second mortgage on May 19, 1988, as of which time the fair market value of the residence is \$55,000.

(ii) For purposes of determining the applicable debt limit for each debt, the fair market value of the residence is generally determined as of the time the debt is first secured. Accordingly, the fair market value would be \$50,000 and \$55,000 with respect to the first and second mortgage, respectively. Under the special rule of paragraph (f)(2)(i) of this section, however, the fair market value with respect to both debts in 1988 is \$60,000, the adjusted purchase price on December 31, 1988.

(g) Selection of method. For any taxable year, a taxpayer may use the simplified method (described in paragraph (d) of this section) or the exact method (described in paragraph (e) of this section) by completing the appropriate portion of Form 8598. A taxpayer with two qualified residences may use the simplified method for one residence and the exact method for the other residence.

(h) Average balance-(1) Average balance defined. For purposes of this section, the term "average balance" means the amount determined under this paragraph (h). A taxpayer is not required to use the same method to determine the average balance of all secured debts during a taxable year or of any particular secured debt from one year to the next.

(2) Average balance reported by lender. If a lender that is subject to section 6050H (returns relating to mortgage interest received in trade or business from individuals) reports the average balance of a secured debt on Form 1098, the taxpayer may use the average balance so reported.

(3) Average balance computed on a daily basis-

(i) In general. The average balance may be determined by-

(A) Adding the outstanding balance of a debt on each day during the taxable year that the debt is secured by a qualified residence, and

(B) Dividing the sum by the number of days during the taxable year that the residence is a qualified residence.

(ii) Example. Taxpayer A incurs a debt of \$10,000 on September 1, 1989, securing the debt with A's principal residence. The residence is A's principal residence during the entire taxable year. A pays current interest on the debt monthly, but makes no principal payments. The debt is, therefore, outstanding for 122 days with a balance each day of \$10,000. The residence is a qualified residence for 365 days. The average balance of the debt for 1989 is \$3,342 ( $122 \times \$10,000/365$ ).

(4) Average balance computed using the interest rate-

(i) In general. If all accrued interest on a secured debt is paid at least monthly, the average balance of the secured debt may be determined by dividing the interest paid or accrued during the taxable year while the debt is secured by a qualified residence by the annual interest rate on the debt. If the interest rate on a debt varies during the taxable year, the lowest annual interest rate that applies to the debt during the taxable year must be used for purposes of this paragraph (h)(4). If the residence securing the debt is a qualified residence for less than the entire taxable year, the average balance of any secured debt may be determined by dividing the average balance determined under the preceding sentence by the percentage of the taxable year that the debt is secured by a qualified residence.

(ii) Points and prepaid interest. For purposes of paragraph (h)(4)(i) of this section, the amount of interest paid during the taxable year does not include any amount paid as points and includes prepaid interest only in the year accrued.

(iii) Examples-Example (1). B has a line of credit secured by a qualified residence for the entire taxable year. The interest rate on the debt is 10 percent throughout the taxable year. The principal balance on the debt changes throughout the year. B pays the accrued interest on the debt monthly. B pays \$2,500 in interest

on the debt during the taxable year. The average balance of the debt (\$25,000) may be computed by dividing the total interest paid by the interest rate ( $\$25,000 = \$2,500/0.10$ ).

Example (2). Assume the same facts as in example 1, except that the residence is a qualified residence, and the debt is outstanding, for only one-half of the taxable year and B pays only \$1,250 in interest on the debt during the taxable year. The average balance of the debt may be computed by first dividing the total interest paid by the interest rate ( $\$12,500 = \$1,250/0.10$ ). Second, because the residence is not a qualified residence for the entire taxable year, the average balance must be determined by dividing this amount (\$12,500) by the portion of the year that the residence is qualified (0.50). The average balance is therefore \$25,000 ( $\$12,500/0.50$ ).

(5) Average balance computed using average of beginning and ending balances-

(i) In general. If-

(A) A debt requires level payments at fixed equal intervals (e.g., monthly, quarterly) no less often than semi-annually during the taxable year,

(B) The taxpayer prepays no more than one month's principal on the debt during the taxable year, and

(C) No new amounts are borrowed on the debt during the taxable year,

the average balance of the debt may be determined by adding the principal balance as of the first day of the taxable year that the debt is secured by the qualified residence and the principal balance as of the last day of the taxable year that the debt is secured by the qualified residence and dividing the sum by 2. If the debt is secured by a qualified residence for less than the entire period during the taxable year that the residence is a qualified residence, the average balance may be determined by multiplying the average balance determined under the preceding sentence by a fraction, the numerator of which is the number of days during the taxable year that the debt is secured by the qualified residence and the denominator of which is the number of days during the taxable year that the residence is a qualified residence. For purposes of this paragraph (h)(5)(i), the determination of whether payments are level shall disregard the fact that the amount of the payments may be adjusted

from time to time to take into account changes in the applicable interest rate.

(ii) Example. C borrows \$10,000 in 1988, securing the debt with a second mortgage on a principal residence. The terms of the loan require C to make equal monthly payments of principal and interest so as to amortize the entire loan balance over 20 years. The balance of the debt is \$9,652 on January 1, 1990, and is \$9,450 on December 31, 1990. The average balance of the debt during 1990 may be computed as follows: Balance on first day of the year: \$9,652  
Balance on last day of the year: \$9,450

Average balance:  $\$9,652 + \$9,450 = \$9,551$

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(6) Highest principal balance. The average balance of a debt may be determined by taking the highest principal balance of the debt during the taxable year.

(7) Other methods provided by the Commissioner. The average balance may be determined using any other method provided by the Commissioner by form, publication, revenue ruling, or revenue procedure. Such methods may include methods similar to (but with restrictions different from) those provided in paragraph (h) of this section.

(8) Anti-abuse rule. If, as a result of the determination of the average balance of a debt using any of the methods specified in paragraphs (h) (4), (5), or (6) of this section, there is a significant overstatement of the amount of qualified residence interest and a principal purpose of the pattern of payments and borrowing on the debt is to cause the amount of such qualified residence interest to be overstated, the district director may redetermine the average balance using the method specified under paragraph (h)(3) of this section.

(i) [Reserved.]

(j) Determination of interest paid or accrued during the taxable year-(1) In general. For purposes of determining the amount of qualified residence interest with respect to a secured debt, the amount of interest paid or accrued during the taxable year includes only interest paid or accrued while the debt is secured by a qualified residence.

(2) Special rules for cash-basis taxpayers-(i) Points deductible in year paid under section 461(g)(2). If points described in section 461(g)(2) (certain points paid in respect of debt incurred in connection with the purchase or improvement of a principal residence) are paid with respect to a debt, the amount of such points is qualified residence interest.

(ii) Points and other prepaid interest described in section 461(g)(1). The amount of points or other prepaid interest charged to capital account under section 461(g)(1) (prepaid interest) that is qualified residence interest shall be determined under the rules of paragraphs (c) through (e) of this section in the same manner as any other interest paid with respect to the debt in the taxable year to which such payments are allocable under section 461(g)(1).

(3) Examples.

Example (1). T designates a vacation home as a qualified residence as of October 1, 1987. The home is encumbered by a mortgage during the entire taxable year. For purposes of determining the amount of qualified residence interest for 1987, T may take into account the interest paid or accrued on the secured debt from October 1, 1987, through December 31, 1987.

Example (2). R purchases a principal residence on June 17, 1987. As part of the purchase price, R obtains a conventional 30-year mortgage, secured by the residence. At closing, R pays 2 1/2 points on the mortgage and interest on the mortgage for the period June 17, 1987 through June 30, 1987. The points are actually paid by R and are not merely withheld from the loan proceeds. R incurs no additional secured debt during 1987. Assuming that the points satisfy the requirements of section 461(g) (2), the entire amount of points and the interest paid at closing are qualified residence interest.

Example (3). (i) On July 1, 1987, W borrows \$120,000 to purchase a residence to use as a vacation home. W secures the debt with the residence. W pays 2 points, or \$2,400. The debt has a term of 10 years and requires monthly payments of principal and interest. W is permitted to amortize the points at the rate of \$20 per month over 120 months. W elects to treat the residence as a second residence. W has no other debt secured by the residence. The average balance of the debt in each taxable year

is less than the adjusted purchase price of the residence. W sells the residence on June 30, 1990, and pays off the remaining balance of the debt.

(ii) W is entitled to treat the following amounts of the points as interest paid on a debt secured by a qualified residence-

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1987 .....	\$120=\$20x6 months;
1988 .....	\$240=\$20x12 months;
1989 .....	\$120=\$20x6 months.
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Total .....	\$480

All of the interest paid on the debt, including the allocable points, is qualified residence interest. Upon repaying the debt, the remaining \$1,920 (\$2,400-\$480) in unamortized points is treated as interest paid in 1990 and, because the average balance of the secured debt in 1990 is less than the adjusted purchase price, is also qualified residence interest.

(k) Determination of adjusted purchase price and fair market value-(1) Adjusted purchase price-(i) In general. For purposes of this section, the adjusted purchase price of a qualified residence is equal to the taxpayer's basis in the residence as initially determined under section 1012 or other applicable sections of the Internal Revenue Code, increased by the cost of any improvements to the residence that have been added to the taxpayer's basis in the residence under section 1016(a)(1). Any other adjustments to basis, including those required under section 1033(b) (involuntary conversions), and 1034(e) (rollover of gain or sale of principal residence) are disregarded in determining the taxpayer's adjusted purchase price. If, for example, a taxpayer's second residence is rented for a portion of the year and its basis is reduced by depreciation allowed in connection with the rental use of the property, the amount of the taxpayer's adjusted purchase price in the residence is not reduced. See paragraph (m) of this section for a rule that treats the sum of the grandfathered amounts of all secured debts as the adjusted purchase price of the residence.

(ii) Adjusted purchase price of a qualified residence acquired incident to divorce. [Reserved.]

(iii) Examples-Example (1). X purchases a residence for \$120,000. X's basis, as determined under section 1012, is the cost of the property, or \$120,000. Accordingly, the adjusted purchase price of the residence is initially \$120,000.

Example (2). Y owns a principal residence that has a basis of \$30,000. Y sells the residence for \$100,000 and purchases a new principal residence for \$120,000. Under section 1034, Y does not recognize gain on the sale of the former residence. Under section 1034(e), Y's basis in the new residence is reduced by the amount of gain not recognized. Therefore, under section 1034(e), Y's basis in the new residence is \$50,000 (\$120,000-\$70,000). For purposes of section 163(h), however, the adjusted purchase price of the residence is not adjusted under section 1034(e). Therefore, the adjusted purchase price of the residence is initially \$120,000.

Example (3). Z acquires a residence by gift. The donor's basis in the residence was \$30,000. Z's basis in the residence, determined under section 1015, is \$30,000. Accordingly, the adjusted purchase price of the residence is initially \$30,000.

(2) Fair market value-(i) In general. For purposes of this section, the fair market value of a qualified residence on any date is the fair market value of the taxpayer's interest in the residence on such date. In addition, the fair market value determined under this paragraph (k)(2)(i) shall be determined by taking into account the cost of improvements to the residence reasonably expected to be made with the proceeds of the debt.

(ii) Example. In 1988, the adjusted purchase price of P's second residence is \$65,000 and the fair market value of the residence is \$70,000. At that time, P incurs an additional debt of \$10,000, the proceeds of which P reasonably expects to use to add two bedrooms to the residence. Because the fair market value is determined by taking into account the cost of improvements to the residence that are reasonably expected to be made with the proceeds of the debt, the fair market value of the residence with respect to the

debt incurred in 1988 is \$80,000 (\$70,000+\$10,000).

(3) Allocation of adjusted purchase price and fair market value. If a property includes both a qualified residence and other property, the adjusted purchase price and the fair market value of such property must be allocated between the qualified residence and the other property. See paragraph (p)(4) of this section for rules governing such an allocation.

(l) [Reserved].

(m) Grandfathered amount-(1) Substitution for adjusted purchase price. If, for the taxable year, the sum of the grandfathered amounts, if any, of all secured debts exceeds the adjusted purchase price of the qualified residence, such sum may be treated as the adjusted purchase price of the residence under paragraphs (c), (d) and (e) of this section.

(2) Determination of grandfathered amount-(i) In general. For any taxable year, the grandfathered amount of any secured debt that was incurred on or before August 16, 1986, and was secured by the residence continuously from August 16, 1986, through the end of the taxable year, is the average balance of the debt for the taxable year. A secured debt that was not incurred and secured on or before August 16, 1986, has no grandfathered amount.

(ii) Special rule for lines of credit and certain other debt. If, with respect to a debt described in paragraph (m)(2)(i) of this section, a taxpayer has borrowed any additional amounts after August 16, 1986, the grandfathered amount of such debt is equal to the lesser of-

(A) The average balance of the debt for the taxable year, or

(B) The principal balance of the debt as of August 16, 1986, reduced (but not below zero) by all principal payments after August 16, 1986, and before the first day of the current taxable year.

For purposes of this paragraph (m)(2)(ii), a taxpayer shall not be considered to have borrowed any additional amount with respect to a debt merely because accrued interest is added to the principal balance of the debt, so long as such accrued interest is paid by the taxpayer no less often than quarterly.

(iii) Fair market value limitation. The grandfathered amount of any debt for any taxable year may not exceed the fair market value of the residence on August 16, 1986, reduced by the principal balance on that day of all previously secured debt.

(iv) Examples-Example (1). As of August 16, 1986, T has one debt secured by T's principal residence. The debt is a conventional self-amortizing mortgage and, on August 16, 1986, it has an outstanding principal balance of \$75,000. In 1987, the average balance of the mortgage is \$73,000. The adjusted purchase price of the residence as of the end of 1987 is \$50,000. Because the mortgage was incurred and secured on or before August 16, 1986 and T has not borrowed any additional amounts with respect to the mortgage, the grandfathered amount is the average balance, \$73,000. Because the grandfathered amount exceeds the adjusted purchase price (\$50,000), T may treat the grandfathered amount as the adjusted purchase price in determining the amount of qualified residence interest.

Example (2). (i) The facts are the same as in example (1), except that in May 1986, T also obtains a home equity line of credit that, on August 16, 1986, has a principal balance of \$40,000. In November 1986, T borrows an additional \$10,000 on the home equity line, increasing the balance to \$50,000. In December 1986, T repays \$5,000 of principal on the home equity line. The average balance of the home equity line in 1987 is \$45,000.

(ii) Because T has borrowed additional amounts on the line of credit after August 16, 1986, the grandfathered amount for that debt must be determined under the rules of paragraph (m)(2)(ii) of this section. Accordingly, the grandfathered amount for the line of credit is equal to the lesser of \$45,000, the average balance of the debt in 1987, and \$35,000, the principal balance on August 16, 1986, reduced by all principal payments between August 17, 1986, and December 31, 1986 (\$40,000-\$5,000). The sum of the grandfathered amounts with respect to the residence is \$108,000 (\$73,000+\$35,000). Because the sum of the grandfathered amounts exceeds the adjusted purchase price (\$50,000), T may treat the sum as the adjusted purchase price in determining the qualified residence interest for 1987.

(3) Refinancing of grandfathered debt-(i) In general. A debt incurred and secured on or before August 16, 1986, is refinanced if some or all of the outstanding balance of such a debt (the "original debt") is repaid out of the proceeds of a second debt secured by the same qualified residence (the "replacement debt"). In the case of a refinancing, the replacement debt is treated as a debt incurred and secured on or before August 16, 1986, and the grandfathered amount of such debt is the amount (but not less than zero) determined pursuant to paragraph (m)(3)(ii) of this section.

(ii) Determination of grandfathered amount-(A) Exact refinancing. If-

(1) The entire proceeds of a replacement debt are used to refinance one or more original debts, and

(2) The taxpayer has not borrowed any additional amounts after August 16, 1986, with respect to the original debt or debts,

the grandfathered amount of the replacement debt is the average balance of the replacement debt. For purposes of the preceding sentence, the fact that proceeds of a replacement debt are used to pay costs of obtaining the replacement debt (including points or other closing costs) shall be disregarded in determining whether the entire proceeds of the replacement debt have been used to refinance one or more original debts.

(B) Refinancing other than exact refinancings-

(1) Year of refinancing. In the taxable year in which an original debt is refinanced, the grandfathered amount of the original and replacement debts is equal to the lesser of-

(i) The sum of the average balances of the original debt and the replacement debt, and

(ii) The principal balance of the original debt as of August 16, 1986, reduced by all principal payments on the original debt after August 16, 1986, and before the first day of the current taxable year.

(2) In subsequent years. In any taxable year after the taxable year in which an original debt is refinanced, the grandfathered amount of the replacement debt is equal to the least of-

(i) The average balance of the replacement debt for the taxable year,

(ii) The amount of the replacement debt used to repay the principal balance of the original debt, reduced by all principal payments on the replacement debt after the date of the refinancing and before the first day of the current taxable year, or

(iii) The principal balance of the original debt on August 16, 1986, reduced by all principal payments on the original debt after August 16, 1986, and before the date of the refinancing, and further reduced by all principal payments on the replacement debt after the date of the refinancing and before the first day of the current taxable year.

(C) Example-(i) Facts. On August 16, 1986, T has a single debt secured by a principal residence with a balance of \$150,000. On July 1, 1988, T refinances the debt, which still has a principal balance of \$150,000, with a new secured debt. The principal balance of the replacement debt throughout 1988 and 1989 is \$150,000. The adjusted purchase price of the residence is \$100,000 throughout 1987, 1988 and 1989. The average balance of the original debt was \$150,000 in 1987 and \$75,000 in 1988. The average balance of the replacement debt is \$75,000 in 1988 and \$150,000 in 1989.

(ii) Grandfathered amount in 1987. The original debt was incurred and secured on or before August 16, 1986 and T has not borrowed any additional amounts with respect to the debt. Therefore, its grandfathered amount in 1987 is its average balance (\$150,000). This amount is treated as the adjusted purchase price for 1987 and all of the interest paid on the debt is qualified residence interest.

(iii) Grandfathered amount in 1988. Because the replacement debt was used to refinance a debt incurred and secured on or before August 16, 1986, the replacement debt is treated as a grandfathered debt. Because all of the proceeds of the replacement debt were used in the refinancing and because no amounts have been borrowed after August 16, 1986, on the original debt, the grandfathered amount for the original debt is its average balance (\$75,000) and the grandfathered amount for the replacement debt is its average balance (\$75,000). Since the sum of the grandfathered amounts (\$150,000) exceeds the adjusted purchase price of the residence, the sum of the grandfathered amounts

may be substituted for the adjusted purchase price for 1988 and all of the interest paid on the debt is qualified residence interest.

(iv) Grandfathered amount in 1989. The grandfathered amount for the placement debt is its average balance (\$150,000). This amount is treated as the adjusted purchase price for 1989 and all of the interest paid on the mortgage is qualified residence interest.

(4) Limitation on term of grandfathered debt-(i) In general. An original debt or replacement debt shall not have any grandfathered amount in any taxable year that begins after the date, as determined on August 16, 1986, that the original debt was required to be repaid in full (the "maturity date"). If a replacement debt is used to refinance more than one original debt, the maturity date is determined by reference to the original debt that, as of August 16, 1986, had the latest maturity date.

(ii) Special rule for nonamortizing debt. If an original debt was actually incurred and secured on or before August 16, 1986, and if as of such date the terms of such debt did not require the amortization of its principal over its original term, the maturity date of the replacement debt is the earlier of the maturity date of the replacement debt or the date 30 years after the date the original debt is first refinanced.

(iii) Example. C incurs a debt on May 10, 1986, the final payment of which is due May 1, 2006. C incurs a second debt on August 11, 1990, with a term of 20 years and uses the proceeds of the second debt to refinance the first debt. Because, under paragraph (m)(4)(i) of this section, a replacement debt will not have any grandfathered amount in any taxable year that begins after the maturity date of the original debt (May 1, 2006), the second debt has no grandfathered amount in any taxable year after 2006.

(n) Qualified indebtedness (secured debt used for medical and educational purposes)-(1) In general-(i) Treatment of qualified indebtedness. The amount of any qualified indebtedness resulting from a secured debt may be added to the adjusted purchase price under paragraph (e)(2)(i)(B) of this section to determine the applicable debt limit for that secured debt and any other debt subsequently secured by the qualified residence.

(ii) Determination of amount of qualified indebtedness. If, as of the end of the taxable year (or the last day in the taxable year that the debt is secured), at least 90 percent of the proceeds of a secured debt are used (within the meaning of paragraph (n)(2) of this section) to pay for qualified medical and educational expenses (within the meaning of paragraphs (n)(3) and (n)(4) of this section), the amount of qualified indebtedness resulting from that debt for the taxable year is equal to the average balance of such debt for the taxable year.

(iii) Determination of amount of qualified indebtedness for mixed-use debt. If, as of the end of the taxable year (or the last day in the taxable year that the debt is secured), more than ten percent of the proceeds of a secured debt are used to pay for expenses other than qualified medical and educational expenses, the amount of qualified indebtedness resulting from that debt for the taxable year shall equal the lesser of-

(A) The average balance of the debt, or

(B) The amount of the proceeds of the debt used to pay for qualified medical and educational expenses through the end of the taxable year, reduced by any principal payments on the debt before the first day of the current taxable year.

(iv) Example. (i) C incurs a \$10,000 debt on April 20, 1987, which is secured on that date by C's principal residence. C immediately uses (within the meaning of paragraph (n)(2) of this section) \$4,000 of the proceeds of the debt to pay for a qualified medical expense. C makes no principal payments on the debt during 1987. During 1988 and 1989, C makes principal payments of \$1,000 per year. The average balance of the debt during 1988 is \$9,500 and the average balance during 1989 is \$8,500.

(ii) Under paragraph (n)(1)(iii) of this section, C determines the amount of qualified indebtedness for 1988 as follows:

-----	
Average balance .....	\$9,500
Amount of debt used to pay for qualified medical expenses ...	\$4,000
Less payments of principal before 1988 .....	\$0
-----	
Net qualified expenses .....	\$4,000
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The amount of qualified indebtedness for 1988 is, therefore, \$4,000 (lesser of \$9,500 average balance or \$4,000 net qualified expenses). This

amount may be added to the adjusted purchase price of C's principal residence under paragraph (e)(2)(i)(B) of this section for purposes of computing the applicable debt limit for this debt and any other debt subsequently secured by the principal residence.

(iii) C determines the amount of qualified indebtedness for 1989 as follows:

-----	
Average balance .....	\$8,500
Amount of debt used to pay for qualified medical expenses ...	\$4,000
Less payments of principal before 1988 .....	\$1,000 -----
Net qualified expenses .....	\$3,000

The amount of qualified indebtedness for 1989 is, therefore, \$3,000 (lesser of \$8,500 average balance or \$3,000 net qualified expenses).

(v) Prevention of double counting in year of refinancing-(A) In general. A debt used to pay for qualified medical or educational expenses is refinanced if some or all of the outstanding balance of the debt (the "original debt") is repaid out of the proceeds of a second debt (the "replacement debt"). If, in the year of a refinancing, the combined qualified indebtedness of the original debt and the replacement debt exceeds the combined qualified expenses of such debts, the amount of qualified indebtedness for each such debt shall be determined by multiplying the amount of qualified indebtedness for each such debt by a fraction, the numerator of which is the combined qualified expenses and the denominator of which is the combined qualified indebtedness.

(B) Definitions. For purposes of paragraph (n)(1)(v)(A) of this section-

(1) The term "combined qualified indebtedness" means the sum of the qualified indebtedness (determined without regard to paragraph (n)(1)(v) of this section) for the original debt and the replacement debt.

(2) The term "combined qualified expenses" means the amount of the proceeds of the original debt used to pay for qualified medical and educational expenses through the end of the current taxable year, reduced by any principal payments on the debt before the first day of the current taxable year, and increased by the amount, if any, of the proceeds of the

replacement debt used to pay such expenses through the end of the current taxable year other than as part of the refinancing.

(C) Example. (i) On August 11, 1987, C incurs a \$8,000 debt secured by a principal residence. C uses (within the meaning of paragraph (n)(2)(i) of this section) \$5,000 of the proceeds of the debt to pay for qualified educational expenses. C makes no principal payments on the debt. On July 1, 1988, C incurs a new debt in the amount of \$8,000 secured by C's principal residence and uses all of the proceeds of the new debt to repay the original debt. Under paragraph (n)(2)(ii) of this section \$5,000 of the new debt is treated as being used to pay for qualified educational expenses. C makes no principal payments (other than the refinancing) during 1987 or 1988 on either debt and pays all accrued interest monthly. The average balance of each debt in 1988 is \$4,000.

(ii) Under paragraph (n)(1)(iii) of this section, the amount of qualified indebtedness for 1988 with respect to the original debt is \$4,000 (the lesser of its average balance (\$4,000) and the amount of the debt used to pay for qualified medical and educational expenses (\$5,000)). Similarly, the amount of qualified indebtedness for 1988 with respect to the replacement debt is also \$4,000. Both debts, however, are subject in 1988 to the limitation in paragraph (n)(1)(v)(A) of this section. The combined qualified indebtedness, determined without regard to the limitation, is \$8,000 (\$4,000 of qualified indebtedness from each debt). The combined qualified expenses are \$5,000 (\$5,000 from the original debt and \$0 from the replacement debt). The amount of qualified indebtedness from each debt must, therefore, be reduced by a fraction, the numerator of which is \$5,000 (the combined qualified expenses) and the denominator of which is \$8,000 (the combined qualified indebtedness). After application of the limitation, the amount of qualified indebtedness for the original debt is \$2,500 ( $\$4,000 \times 5/8$ ). Similarly, the amount of qualified indebtedness for the replacement debt is \$2,500. Note that the total qualified indebtedness for both the original and the replacement debt is \$5,000 ( $\$2,500 + \$2,500$ ). Therefore, C is entitled to the same amount of qualified indebtedness as C would have been entitled to if C had not refinanced the debt.



(vi) Special rule for principal payments in excess of qualified expenses. For purposes of paragraph (n)(1)(iii)(B), (n)(1)(v)(B)(2) and (n)(2)(ii) of this section, a principal payment is taken into account only to the extent that the payment, when added to all prior payments, does not exceed the amount used on or before the date of the payment to pay for qualified medical and educational expenses.

(2) Debt used to pay for qualified medical or educational expenses-(i) In general. For purposes of this section, the proceeds of a debt are used to pay for qualified medical or educational expenses to the extent that-

(A) The taxpayer pays qualified medical or educational expenses within 90 days before or after the date that amounts are actually borrowed with respect to the debt, the proceeds of the debt are not directly allocable to another expense under §1.163-8T(c)(3) (allocation of debt; proceeds not disbursed to borrower) and the proceeds of any other debt are not allocable to the medical or educational expenses under §1.163-8T(c)(3), or

(B) The proceeds of the debt are otherwise allocated to such expenditures under §1.163-8T.

(ii) Special rule for refinancings. For purposes of this section, the proceeds of a debt are used to pay for qualified medical and educational expenses to the extent that the proceeds of the debt are allocated under §1.163-8T to the repayment of another debt (the "original debt"), but only to the extent of the amount of the original debt used to pay for qualified medical and educational expenses, reduced by any principal payments on such debt up to the time of the refinancing.

(iii) Other special rules. The following special rules apply for purposes of this section.

(A) Proceeds of a debt are used to pay for qualified medical or educational expenses as of the later of the taxable year in which such proceeds are borrowed or the taxable year in which such expenses are paid.

(B) The amount of debt which may be treated as being used to pay for qualified medical or educational expenses may not exceed the amount of such expenses.

(C) Proceeds of a debt may not be treated as being used to pay for qualified medical or educational expenses to the extent that:

(1) The proceeds have been repaid as of the time the expense is paid;

(2) The proceeds are actually borrowed before August 17, 1986; or

(3) The medical or educational expenses are paid before August 17, 1986.

(iv) Examples-Example (1). A pays a \$5,000 qualified educational expense from a checking account that A maintains at Bank 1 on November 9, 1987. On January 1, 1988, A incurs a \$20,000 debt that is secured by A's residence and places the proceeds of the debt in a savings account that A also maintains at Bank 1. A pays another \$5,000 qualified educational expense on March 15 from a checking account that A maintains at Bank 2. Under paragraph (n)(2) of this section, the debt proceeds are used to pay for both educational expenses, regardless of other deposits to, or expenditures from, the accounts, because both expenditures are made within 90 days before or after the debt was incurred.

Example (2). B pays a \$5,000 qualified educational expense from a checking account on November 1, 1987. On November 30, 1987, B incurs a debt secured by B's residence, and the lender disburses the debt proceeds directly to a person who sells B a new car. Although the educational expense is paid within 90 days of the date the debt is incurred, the proceeds of the debt are not used to pay for the educational expense because the proceeds are directly allocable to the purchase of the new car under §1.163-8T(c)(3).

Example (3). On November 1, 1987, C borrows \$5,000 from C's college. The proceeds of this debt are not disbursed to C, but rather are used to pay tuition fees for C's attendance at the college. On November 30, 1987, C incurs a second debt and secures the debt by C's residence. Although the \$5,000 educational expense is paid within 90 days before the second debt is incurred, the proceeds of the second debt are not used to pay for the educational expense, because the proceeds of the first debt are directly allocable to the educational expense under §1.163-8T(c)(3).

Example (4). On January 1, 1988, D incurs a \$20,000 debt secured by a qualified residence. D places the proceeds of the debt in a separate account (i.e., the proceeds of the debt are the only deposit in the account). D makes payments of \$5,000 each for qualified educational expenses on September 1, 1988, September 1, 1989, September 1, 1990, and September 1, 1991. Because the debt proceeds are allocated to educational expenses as of the date the expenses are paid, under the rules of §1.163-8T(c)(4), the following amounts of the debt proceeds are used to pay for qualified educational expenses as of the end of each year: 1988: \$5,000 1989: \$10,000 1990: \$15,000 1991: \$20,000

Example (5). During 1987 E incurs a \$10,000 debt secured by a principal residence. E uses (within the meaning of paragraph (n)(2)(i) of this section) all of the proceeds of the debt to pay for qualified educational expenses. On August 20, 1988, at which time the balance of the debt is \$9,500, E incurs a new debt in the amount of \$9,500 secured by E's principal residence and uses all of the proceeds of the new debt to repay the original debt. Under paragraph (n)(2)(ii) of this section, all of the proceeds of the new debt are used to pay for qualified educational expenses.

(3) Qualified medical expenses. Qualified medical expenses are amounts that are paid for medical care (within the meaning of section 213(d)(1) (A) and (B)) for the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer (within the meaning of section 152), and that are not compensated for by insurance or otherwise.

(4) Qualified educational expenses. Qualified educational expenses are amounts that are paid for tuition, fees, books, supplies and equipment required for enrollment, attendance or courses of instruction at an educational organization described in section 170(b) (1)(A)(ii) and for any reasonable living expenses while away from home while in attendance at such an institution, for the taxpayer, the taxpayer's spouse or a dependent of the taxpayer (within the meaning of section 152) and that are not reimbursed by scholarship or otherwise.

(o) Secured debt-(1) In general. For purposes of this section, the term "secured debt" means a debt that is on the security of any instrument

(such as a mortgage, deed of trust, or land contract)-

(i) That makes the interest of the debtor in the qualified residence specific security for the payment of the debt,

(ii) Under which, in the event of default, the residence could be subjected to the satisfaction of the debt with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated, and

(iii) That is recorded, where permitted, or is otherwise perfected in accordance with applicable State law.

A debt will not be considered to be secured by a qualified residence if it is secured solely by virtue of a lien upon the general assets of the taxpayer or by a security interest, such as a mechanic's lien or judgment lien, that attaches to the property without the consent of the debtor.

(2) Special rule for debt in certain States. Debt will not fail to be treated as secured solely because, under an applicable State or local homestead law or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted.

(3) Times at which debt is treated as secured. For purposes of this section, a debt is treated as secured as of the date on which each of the requirements of paragraph (o)(1) of this section are satisfied, regardless of when amounts are actually borrowed with respect to the debt. For purposes of this paragraph (o)(3), if the instrument is recorded within a commercially reasonable time after the security interest is granted, the instrument will be treated as recorded on the date that the security interest was granted.

(4) Partially secured debt-(i) In general. If the security interest is limited to a prescribed maximum amount or portion of the residence, and the average balance of the debt exceeds such amount or the value of such portion, such excess shall not be treated as secured debt for purposes of this section.

(ii) Example. T borrows \$80,000 on January 1, 1991. T secures the debt with a principal residence. The security in the residence for the debt, however, is limited to \$20,000. T pays

\$8,000 in interest on the debt in 1991 and the average balance of the debt in that year is \$80,000. Because the average balance of the debt exceeds the maximum amount of the security interest, such excess is not treated as secured debt. Therefore, for purposes of applying the limitation on qualified residence interest, the average balance of the secured debt is \$20,000 (the maximum amount of the security interest) and the interest paid or accrued on the secured debt is \$2,000 (the total interest paid on the debt multiplied by the ratio of the average balance of the secured debt (\$20,000) and the average balance of the total debt (\$80,000)).

(5) Election to treat debt as not secured by a qualified residence-(i) In general. For purposes of this section, a taxpayer may elect to treat any debt that is secured by a qualified residence as not secured by the qualified residence. An election made under this paragraph shall be effective for the taxable year for which the election is made and for all subsequent taxable years unless revoked with the consent of the Commissioner.

(ii) Example. T owns a principal residence with a fair market value of \$75,000 and an adjusted purchase price of \$40,000. In 1988, debt A, the proceeds of which were used to purchase the residence, has an average balance of \$15,000. The proceeds of debt B, which is secured by a second mortgage on the property, are allocable to T's trade or business under §1.163-8T and has an average balance of \$25,000. In 1988, T incurs debt C, which is also secured by T's principal residence and which has an average balance in 1988 of \$5,000. In the absence of an election to treat debt B as unsecured, the applicable debt limit for debt C in 1988 under paragraph (e) of this section would be zero dollars (\$40,000-\$15,000-\$25,000) and none of the interest paid on debt C would be qualified residence interest. If, however, T makes or has previously made an election pursuant to paragraph (o)(5)(i) of this section to treat debt B as not secured by the residence, the applicable debt limit for debt C would be \$25,000 (\$40,000-\$15,000), and all of the interest paid on debt C during the taxable year would be qualified residence interest. Since the proceeds of debt B are allocable to T's trade or business under §1.163-8T, interest on debt B may be deductible under other sections of the Internal Revenue Code.

(iii) Allocation of debt secured by two qualified residences. [Reserved.]

(p) Definition of qualified residence-(1) In general. The term "qualified residence" means the taxpayer's principal residence (as defined in paragraph (p)(2) of this section), or the taxpayer's second residence (as defined in paragraph (p)(3) of this section).

(2) Principal residence. The term "principal residence" means the taxpayer's principal residence within the meaning of section 1034. For purposes of this section, a taxpayer cannot have more than one principal residence at any one time.

(3) Second residence-(i) In general. The term "second residence" means-

(A) A residence within the meaning of paragraph (p)(3)(ii) of this section,

(B) That the taxpayer uses as a residence within the meaning of paragraph (p)(3)(iii) of this section, and

(C) That the taxpayer elects to treat as a second residence pursuant to paragraph (p)(3)(iv) of this section.

A taxpayer cannot have more than one second residence at any time.

(ii) Definition of residence. Whether property is a residence shall be determined based on all the facts and circumstances, including the good faith of the taxpayer. A residence generally includes a house, condominium, mobile home, boat, or house trailer, that contains sleeping space and toilet and cooking facilities. A residence does not include personal property, such as furniture or a television, that, in accordance with the applicable local law, is not a fixture.

(iii) Use as a residence. If a residence is rented at any time during the taxable year, it is considered to be used as a residence only if the taxpayer uses it during the taxable year as a residence within the meaning of section 280A(d). If a residence is not rented at any time during the taxable year, it shall be considered to be used as a residence. For purposes of the preceding sentence, a residence will be deemed to be rented during any period that the taxpayer holds the residence out for rental or resale or repairs or renovates the residence with the intention of holding it out for rental or resale.

(iv) Election of second residence. A taxpayer may elect a different residence (other than the taxpayer's principal residence) to be the taxpayer's second residence for each taxable year. A taxpayer may not elect different residences as second residences at different times of the same taxable year except as provided below-

(A) If the taxpayer acquires a new residence during the taxable year, the taxpayer may elect the new residence as a taxpayer's second residence as of the date acquired;

(B) If property that was the taxpayer's principal residence during the taxable year ceases to qualify as the taxpayer's principal residence, the taxpayer may elect that property as the taxpayer's second residence as of the date that the property ceases to be the taxpayer's principal residence; or

(C) If property that was the taxpayer's second residence is sold during the taxable year or becomes the taxpayer's principal residence, the taxpayer may elect a new second residence as of such day.

(4) Allocations between residence and other property-(i) In general. For purposes of this section, the adjusted purchase price and fair market value of property must be allocated between the portion of the property that is a qualified residence and the portion that is not a qualified residence. Neither the average balance of the secured debt nor the interest paid or accrued on secured debt is so allocated. Property that is not used for residential purposes does not qualify as a residence. For example, if a portion of the property is used as an office in the taxpayer's trade or business, that portion of the property does not qualify as a residence.

(ii) Special rule for rental of residence. If a taxpayer rents a portion of his or her principal or second residence to another person (a "tenant"), such portion may be treated as used by the taxpayer for residential purposes if, but only if-

(A) Such rented portion is used by the tenant primarily for residential purposes,

(B) The rented portion is not a self-contained residential unit containing separate sleeping space and toilet and cooking facilities, and

(C) The total number of tenants renting (directly or by sublease) the same or different portions of the residence at any time during the taxable year does not exceed two. For this purpose, if two persons (and the dependents, as defined by section 152, of either of them) share the same sleeping quarters, they shall be treated as a single tenant.

(iii) Examples-Example (1). D, a dentist, uses a room in D's principal residence as an office which qualifies under section 280A(c)(1)(B) as a portion of the dwelling unit used exclusively on a regular basis as a place of business for meeting with patients in the normal course of D's trade or business. D's adjusted purchase price of the property is \$65,000; \$10,000 of which is allocable under paragraph (o)(4)(i) of this section to the room used as an office. For purposes of this section, D's residence does not include the room used as an office. The adjusted purchase price of the residence is, accordingly, \$55,000. Similarly, the fair market value of D's residence must be allocated between the office and the remainder of the property.

Example (2). J rents out the basement of property that is otherwise used as J's principal residence. The basement is a self-contained residential unit, with sleeping space and toilet and cooking facilities. The adjusted purchase price of the property is \$100,000; \$15,000 of which is allocable under paragraph (o)(4)(i) of this section to the basement. For purposes of this section, J's residence does not include the basement and the adjusted purchase price of the residence is \$85,000. Similarly, the fair market value of the residence must be allocated between the basement unit and the remainder of the property.

(5) Residence under construction-(i) In general. A taxpayer may treat a residence under construction as a qualified residence for a period of up to 24 months, but only if the residence becomes a qualified residence, without regard to this paragraph (p)(5)(i), as of the time that the residence is ready for occupancy.

(ii) Example. X owns a residential lot suitable for the construction of a vacation home. On April 20, 1987, X obtains a mortgage secured by the lot and any property to be constructed on the lot. On August 9, 1987, X begins construction of a residence on the lot. The residence is ready for

occupancy on November 9, 1989. The residence is used as a residence within the meaning of paragraph (p)(3)(iii) of this section during 1989 and X elects to treat the residence as his second residence for the period November 9, 1989, through December 31, 1989. Since the residence under construction is a qualified residence as of the first day that the residence is ready for occupancy (November 9, 1987), X may treat the residence as his second residence under paragraph (p)(5)(i) of this section for up to 24 months of the period during which the residence is under construction, commencing on or after the date that construction is begun (August 9, 1987). If X treats the residence under construction as X's second residence beginning on August 9, 1987, the residence under construction would cease to qualify as a qualified residence under paragraph (p)(5)(i) on August 8, 1989. The residence's status as a qualified residence for future periods would be determined without regard to paragraph (p)(5)(i) of this section.

(6) Special rule for time-sharing arrangements. Property that is otherwise a qualified residence will not fail to qualify as such solely because the taxpayer's interest in or right to use the property is restricted by an arrangement whereby two or more persons with interests in the property agree to exercise control over the property for different periods during the taxable year. For purposes of determining the use of a residence under paragraph (p)(3)(iii) of this section, a taxpayer will not be considered to have used or rented a residence during any period that the taxpayer does not have the right to use the property or to receive any benefits from the rental of the property.

(q) Special rules for tenant-stockholders in cooperative housing corporations-(1) In general. For purposes of this section, a residence includes stock in a cooperative housing corporation owned by a tenant-stockholder if the house or apartment which the tenant-stockholder is entitled to occupy by virtue of owning such stock is a residence within the meaning of paragraph (p)(3)(ii) of this section.

(2) Special rule where stock may not be used to secure debt. For purposes of this section, if stock described in paragraph (q)(1) of this section may not be used to secure debt because of restrictions under local or State law or because of

restrictions in the cooperative agreement (other than restrictions the principal purpose of which is to permit the tenant-stockholder to treat unsecured debt as secured debt under this paragraph (q)(2)), debt may be treated as secured by such stock to the extent that the proceeds of the debt are allocated to the purchase of the stock under the rules of §1.163-8T. For purposes of this paragraph (q)(2), proceeds of debt incurred prior to January 1, 1987, may be treated as allocated to the purchase of such stock to the extent that the tenant-stockholder has properly and consistently deducted interest expense on such debt as home mortgage interest attributable to such stock on Schedule A of Form 1040 in determining his taxable income for taxable years beginning before January 1, 1987. For purposes of this paragraph (q)(2), amended returns filed after December 22, 1987, are disregarded.

(3) Treatment of interest expense of the cooperative described in section 216(a)(2). For purposes of section 163(h) and §1.163-9T (disallowance of deduction for personal interest) and section 163(d) (limitation on investment interest), any amount allowable as a deduction to a tenant-stockholder under section 216(a)(2) shall be treated as interest paid or accrued by the tenant-stockholder. If a tenant-stockholder's stock in a cooperative housing corporation is a qualified residence of the tenant-shareholder, any amount allowable as a deduction to the tenant-stockholder under section 216(a)(2) is qualified residence interest.

(4) Special rule to prevent tax avoidance. If the amount treated as qualified residence interest under this section exceeds the amount which would be so treated if the tenant-stockholder were treated as directly owning his proportionate share of the assets and liabilities of the cooperative and one of the principal purposes of the cooperative arrangement is to permit the tenant-stockholder to increase the amount of qualified residence interest, the district director may determine that such excess is not qualified residence interest.

(5) Other definitions. For purpose of this section, the terms "tenant-stockholder," "cooperative housing corporation" and "proportionate share" shall have the meaning given by section 216 and the regulations thereunder.

(r) Effective date. The provisions of this section are effective for taxable years beginning after December 31, 1986.

PART 602-[AMENDED]

Par. 3. The authority for Part 602 continues to read as follows:

Authority:

26 U.S.C. 7805.

§602.10 [Amended]

Par. 4. Section 602.101(c) is amended by inserting in the appropriate place in the table “§1.163-10T . . . 1545-1009.”

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impractical to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,  
Commissioner of Internal Revenue.  
Approved: December 15, 1987.  
O. Donaldson Chapoton,  
Assistant Secretary of the Treasury.