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DEDUCTING INTEREST

— by **Neil E. Harl***

In an effort to curb manipulations by taxpayers on the cash method of accounting, and to limit the deduction of non business interest, taxpayers in recent years have been subjected to increasingly stringent limitations on interest deductibility.[1]

Prepayment of interest. In general, interest paid in advance may be deducted only over the life of the loan.[2] An exception exists for points on indebtedness incurred in connection with the purchase or improvement of the taxpayer's principal residence to the extent that the payment of points is an established practice in the area where the debt was incurred.[3] The IRS position has been that a current deduction is not allowed for points paid[4] in refinancing a mortgage on the principal residence.[5]

The IRS position denying a deduction for points in connection with a refinancing was upheld in *James Richard Huntsman*.[6] However, that case has been reversed on appeal[7] with the IRS indicating, in A.O.D. 1991-02, that the decision will not be followed outside the Eighth Circuit Court of Appeal area. The factors that seemed to influence the appellate court were — (1) the refinanced loans were short-term and were not intended to constitute permanent financing for the home and (2) there was no interest rate advantage to the refinancing.

Legal fees, commissions and other expenses paid in obtaining a farm loan must be allocated and deducted over the term of the loan.[8]

Year-end interest payments. Late year-end interest payments pose special problems where unpaid interest is rolled over into a new loan and the indebtedness continues. Since mid 1983, IRS has indicated that it will deny an interest deduction if the taxpayer borrows funds from the same lender for the purpose of satisfying the interest obligation to that lender.[9]

An important factor in determining if interest payments to a lender are "paid" is whether the borrower exercised unrestricted control over the loan proceeds.[10] Interest is generally considered to be paid if the borrower has unrestricted control over the loan funds. However, in light of the IRS position on rolling over interest into a new loan,[11] a taxpayer should avoid borrowing funds for interest payments from the same lender that furnished the original loan even if unrestricted control is maintained over the loan proceeds.

Graduated payment obligations. In the case of a graduated payment mortgage, where the amount of interest paid is less than the interest due on the loan with the balance deferred, the amount representing deferred interest is generally not deductible until actually paid by the borrower.[12] A deduction may nonetheless be allowed for the deferred interest if funds are later borrowed from a different lender to pay off the original lender.[13]

Shared appreciation mortgages. The deductibility of "contingent" interest on a shared appreciation mortgage has assumed far greater importance with the express authorization of such arrangements for the Farmers Home Administration in the Agricultural Credit Act of 1987 and by the Farm Credit System.[14] The income tax treatment of interest under a shared appreciation mortgage has not been entirely clear.

In a 1983 ruling[15] a taxpayer on the cash method of accounting was allowed to deduct the contingent interest on a shared appreciation mortgage on a residence even though the interest was not computed at a fixed rate. However, the ruling cautions that the conclusions may not apply to commercial or business loans.[16] In the ruling, the residence mortgage provided for 40 percent of the appreciation to be payable when the shared appreciation mortgage terminated. In recent years, the treatment of interest under shared appreciation mortgages has been on the list of areas on which IRS will not rule or issue determination letters.[17]

In 1989, IRS issued a letter (not a letter ruling) providing guidance for handling shared appreciation arrangements under the Agricultural Credit Act of 1987.[18] In the letter, the IRS states that if an FmHA borrower pays an amount under the shared appreciation arrangement (or a recapture agreement), the borrower generally reverses the tax treatment accorded the discharge of indebtedness.[19]

Nonbusiness interest. The Tax Reform Act of 1986[20] phased out the deductibility of interest for nonbusiness indebtedness.[21] For 1991, the deduction is completely phased out.[22]

The phase-out has raised the stakes as to classification of interest as deductible business interest or partially or totally nondeductible personal interest.

The key to assuring interest deductibility is to never place loan proceeds in an account from which nonbusiness expenditures will be paid.[23] Moreover, the detailed rules for

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allocating interest between business and nonbusiness obligations do not apply if the borrowed funds are distributed directly to a third party selling property to or providing services for the borrower such as with a purchase money security interest.[24]

If borrowed funds are commingled with other funds, several principles apply which govern the allocation including the following —

• Any expenditure made from an account within 15 days after debt proceeds are deposited in the account may be treated as made from the debt proceeds.[25]

• In general, an expenditure from a checking or similar account is treated as made at the time the check is written on the account, provided the check is delivered or mailed to the payee within a reasonable time.[26]

• After borrowed funds are deposited in an account, amounts held in the account are treated as held for investment but are reallocated if used for another expenditure.[27]

• If an account already contains nonborrowed funds, the amounts first expended are considered to be borrowed funds.[28]

• Interest on the proceeds of a loan used to pay off existing indebtedness is characterized the same as interest on the original loan.[29]

• If loan proceeds are used to purchase an interest in an S corporation or partnership, the interest expense associated with those proceeds is to be allocated, using any reasonable method, among the assets of the corporation or partnership.[30] Under this authority, the interest is reported by individuals on Schedules A or E or on a separate form as follows—

–Interest expense allocated to trade or business expenditures is reported on Part II of Schedule E.

–Interest expense allocated to passive activities is reported on Form 8582.

–Interest expense allocated to investment expenditures is reported on Form 4952.

–Interest expense allocated to personal expenditures is reported on Schedule A if it is deductible at all.

For other taxpayers, interest expense is reported on the line for interest expense on their tax returns.

If an S corporation or partnership distributes the proceeds of a loan to shareholders or partners, as the case may be, the interest expense associated with those proceeds is to be allocated according to the use made of those proceeds by the shareholder or partner receiving the distribution.[31]

FOOTNOTES

1 E.g., I.R.C. § 163(d) (limit on deductions of interest for investment indebtedness). See generally 4 Harl, Agricultural Law § 28.05[3] (1991).

2 I.R.C. § 461(g)(1).

3 I.R.C. § 461(g)(2).

4 Recipients of mortgage interest must report points on financing. I.R.C. § 6050H(b)(2)(C). See Notice 90-70, I.R.B. 1990-48.

5 Rev. Rul. 87-22, 1987-1 C.B. 146 (current deduction allowed for points paid in refinancing mortgage on principal residence only to extent new loan proceeds used for home improvements). See Rev. Proc. 87-15, 1987-1 C.B. 624 (method for deducting points over period of indebtedness).

6 91 T.C. 917 (1988).

7 Huntsman v. Comm'r, 905 F.2d 1182 (8th Cir. 1990).

8 Rev. Rul. 70-360, 1970-2 C.B. 103.

9 IR News Rel. 83-93, July 6, 1983. See Wilkerson v. Comm'r, 655 F.2d 980 (9th Cir. 1981), *rev'g*, 70 T.C. 240 (1978); Battelstein v. IRS, 631 F.2d 1182 (5th Cir. 1980), *cert. denied*, 451 U.S. 938 (11981). See also Menz v. Comm'r, 80 T.C. 1174 (1983).

10 See Noble v. Comm'r, 79 T.C. 751 (1982).

11 See note 9 *supra* and accompanying text.

12 Rev. Rul. 77-135, 1977-1 C.B. 133.

13 Ltr. Rul. 8346015, Aug. 10, 1983.

14 Pub. L. 100-233, 101 Stat. 1637 (1988).

15 Rev. Rul. 83-51, 1983-1 C.B. 48.

16 *Id*.

17 Rev. Proc. 91-3, I.R.B. 1991-1, 52.

18 Letter from the Office of Chief Counsel, IRS, to Farmer Program Division, FmHA, dated May 22, 1989 (reproduced in full in App. 39-C, 4 Harl, *supra* note 1).

19 *Id*.

20 Pub. L. 99-514. 100 Stat. 2246 (1986).

21 I.R.C. § 163(h).

22 *Id*.

23 See Temp.Treas.Reg. § 1.163-8T(c).

24 Temp. Treas. Reg. § 1.163-8T(c)(3).

25 Temp. Treas. Reg. § 1.163-8T(c)(4)(iii)(B).

26 Temp. Treas. Reg. § 1.163-8T(c)(4)(iii)(A).

27 Temp. Treas. Reg. § 1.163-8T(c)(4)(i).

28 Temp. Treas. Reg. § 1.163-8T(c)(4)(ii)(A).

29 Temp. Treas. Reg. § 1.163-8T(c)(6)(ii).

30 See Notice 89-35, 1989-1 C.B. 675 (rules provided in notice may not be used by taxpayers forming corporation or partnership with intent to use rules to circumvent Temp. Treas. Reg. § 1.168-8T).

31 *Id*.

ELIGIBILITY FOR EXPENSE METHOD DEPRECIATION

by Neil E. Harl

The Revenue Reconciliation Act of 1990, **Pub. L. No. 101-508, 104 Stat. 1388 (1990)**, has amended the eligibility requirements for expense method depreciation for property placed in service after 1990. ***Id*., Sec. 11801**. Before the amendment, expense method depreciation was limited to "Section 38 property," **I.R.C. § 48(a)**, which was originally enacted for purposes of investment tax credit eligibility and which excluded horses from eligibility for investment tax credit and thus from expense method depreciation. **I.R.C. § 48(a)(6)**.

The 1990 amendment substituted "Section 1245 property" for "Section 38 property" for purposes of expense