

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

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 first and second mortgages (\$59,900) is

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

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

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-

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

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 residence05495()-0.478582(s)-

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

(3) Refinancing of grandfathered debt-(i) In

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
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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).

\$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

(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

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

(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