Essay Question 1 Model Answer

Question 1:

In general, interest paid is deductible. §163(a). However, for non-corporate taxpayers, interest paid is not deductible unless incurred in connection with profit-seeking activity, §163(h)(1), unless the interest is "qualified residence interest" within the meaning of §163(h)(3). Here, the interest will be "qualified residence interest" because the loan is "acquisition indebtedness" because the loan was incurred to acquire Homeowner's ("H") personal residence. However, the loan must be secured by the residence and, if it is not H's primary residence, then it must be his designated secondary residence. §163(h)(4)(A).

Question 2:

While the refinance loan is not "acquisition indebtedness" because it is not used to "acquir[e], construct[], or substantially improv[e]" the residence, it is treated as "acquisition indebtedness" to the extent it replaces "acquisition indebtedness." §163(h)(3)(B) (final flush language). Here, that means that only 300,000/420,000 of the interest will be deductible as "acquisition indebtedness" (assuming the original loan was "acquisition indebtedness"). Because this loan is "nonrecourse," it must be secured by something, and the only asset in the fact pattern is the residence. Of the interest on the remaining $120,000, 100,000/120,000 may be deductible because the loan may qualify as "home equity indebtedness" under §163(h)(3)(C) if it is secured by the residence. (Note that as the loan principal is paid down, a greater percentage of the loan will qualify as "home equity indebtedness.")

However, even if $100,000 of the excess loan amount is treated as "home equity indebtedness," the interest may not be deductible by reason of §265(a)(2). One would think that §265 would not trump §163(h)(3): there is no greater reason why interest used to acquire exempt securities should be nondeductible as compared with, for example, interest on a loan used to take a personal trip around the world. However, §265 provides that "no deduction shall be allowed" for interest used to purchase or carry exempt securities, and this disallowance provision literally applies even to home equity indebtedness. Thus, a literal reading of §265 implies it will deny the home equity loan interest expense, and the government has adopted that literal interpretation.

Question 3:

Because H is assumed to be a cash-basis taxpayer, deductible expenses are allowed when paid. Reg. §1.446-1(c)(1)(i). However, even for a cash-basis taxpayer, pre-paid interest is deductible only as it accrues. §461(g)(1). There is an exception to this mandatory accrual for certain points paid on loans incurred in connection with the purchase or improvement of a taxpayer's principal residence, see §461(g)(2), but this exception does not apply to the refinancing of such qualified loans. Thus, H may deduct the points, to the extent they otherwise are deductible, over the term of the new loan.

Question 4:

On the sale to T, H realizes gain equal to the excess of the amount realized over H's adjusted basis in the property. §1001(a). Immediately prior to the transaction, H's adjusted basis in the property equals cost of $500,000 (initial purchase price plus cost of capital improvement). Because no

depreciation is allowed with respect to property held primarily for personal use, H's adjusted basis in the property should not have changed over time. If the refinance loan is now paid off, any remaining deductible points can now be deducted.

Following *Alstores Realty*, there are two ways to characterize the sale transaction: (1) a sale of the entire property along with a simultaneous leaseback or (2) a sale of the remainder following expiration of the retained life estate. Ignoring the garage agreement, under (1) H should be treated as receiving an amount realized of $550,000 and then paying $200,000 for the retained life estate. From this perspective, H has a capital gain on the sale of $50,000 along with nondeductible rent of $200,000. Under (2), since H is selling only a portion of the property, H should be allowed to recover only a portion of H's adjusted basis: that portion equals 350,000 over 550,000, and gain or loss should be computed by comparing this allowable adjusted basis with the purchase price of $350,000; if there is a loss, it is nondeductible because the home was used primarily as H's personal residence. See §165(c). H's remaining adjusted basis should be nondeductible as the equivalent of personal rent (but see below).

Should characterization (1) or (2) apply? In *Alstores Realty*, the court looked to a variety of minor factors such as which party had the right to condemnation proceeds and who was required to pay utilities and insurance; no such facts are provided here. However, the parties can allocate these minor incidents however they desire and then adjust the purchase price as needed, making the tax characterization effectively elective. If well-advised taxpayers can in effect elect the outcome, there seems no good reason not to make the tax characterization formally elective by following the form adopted by the taxpayer. If that analysis is followed, this transaction will be treated as the sale of a remainder because no rental agreement was signed by the parties.

If T uses the home as a personal residence, then T's adjusted basis will be either $350,000 or $550,000, depending on the characterization described above. If the transaction is treated as the purchase of the entire property, then T will have rental income of $200,000. If the transaction is treated as the purchase of only a remainder interest, then T will enjoy a $200,000 accession to wealth over the term of the life estate. That accession will not result in income to T under the realization doctrine as interpreted by the Supreme Court in *Irvin v. Gavit*.

Construction of the garage should add $25,000 to H's adjusted basis. However, if the transaction is treated as the sale of a remainder, then H's allowable basis on the transaction will be increased by only 350,000/550,000 of that amount. Note, though, that the cost of the garage comes after the sale, so it seems impossible to add the cost to H's adjusted basis. Presumably a loss should be allowed under §165 (or a deduction allowed under §212) when the cost is incurred, with characterization determined under *Arrowsmith*.

Question 5

The unexpected death of H represents a sudden loss of value to H and a sudden accession to wealth for T. Can H claim (on H's final return, filed by H's executor) a casualty loss under §165(c)(3) for H's adjusted basis in the remainder interest (or in the capitalized, pre-paid rent)? H's death certainly triggers a "closed and completed" transaction, see Reg. §1.165-1(d)(1). However, death of an individual seems to lack the unexpected element common to "fire, storm, shipwreck." In addition, the Tax Court has held that a loss arising from "sickness" can never qualify under §165(c)(3). Finally, H's death did not have any destructive impact on any "property"; the house is unaffected by the death. See *Chamales* (the neighbors of OJ Simpson's late ex-wife). Thus, the loss

likely will be denied. But H's unexpected death eliminates approximately $200,000 of expected consumption for H; denying H the loss overtaxes H by that amount over H's lifetime.

To T, H's early death is the economic equivalent of winning a bet. But because there has been no change in the form of any property owned by T and T's accession to wealth cannot properly be characterized as time-value-of-money, the realization doctrine presumably precludes taxation. Further, the Supreme Court has held in similar circumstances that T has no income. *Helvering v. Bruun* (a case not assigned this semester).