Can Interest on a Home Equity Loan Be Deducted on Schedule C?

By David M. Fogel, EA, CPA

Introduction

Consider the following scenario. A client who operates a sole proprietorship owns a principal residence that is free of debt. She obtains a home equity line of credit (HELOC) and borrows $250,000 to purchase some equipment for her business. During the year, she pays $10,000 interest on the loan. Is the interest deductible as a business expense on Schedule C or as interest on home equity debt on Schedule A, or apportioned between the two schedules?

Deducting the interest on Schedule C will reduce her net profit and may result in a significant savings in self-employment tax. If, instead, the interest is deductible on Schedule A, and if the client's Adjusted Gross Income (AGI) is high enough, due to the AGI phase-out of itemized deductions, then she might not be able to deduct all of the interest.

The client can make an election to treat the HELOC as not secured by the residence, and this election will allow her to deduct all of the interest on Schedule C, but as discussed in this article, there might be a downside to making the election if she intends to use the HELOC to borrow additional amounts in the future.

Background

For tax years beginning after 1986, in the case of a taxpayer other than a corporation, personal interest is no longer deductible.[1] All interest is considered to be personal interest, except for interest on debt allocable to a business, investment interest, interest relating to a passive activity, qualified residence interest, and a couple of other categories.[2]

Qualified residence interest is defined as interest paid on acquisition debt and home equity debt.[3] The deduction for qualified residence interest is limited to the interest on $1 million of acquisition debt and $100,000 of home equity debt.[4] Acquisition debt means debt incurred in acquiring, constructing, or substantially improving the taxpayer's qualified residence that is also secured by the residence.[5] Home equity debt means debt other than acquisition debt that is secured by the taxpayer's qualified residence and that doesn't exceed the excess of the fair market value of the qualified residence over the acquisition debt.[6]

In the situation described above, the interest on the $250,000 HELOC qualifies under both the home equity debt and business debt exceptions to personal interest. If the interest is allocable to the client's business, then it's deductible on Schedule C. If it it is considered interest on home equity debt, then it's partly deductible (interest on $100,000 of the $250,000 debt) on Schedule A and partly deductible on Schedule C. Does the client get to choose which category she wants to use to deduct the interest? Does one category take precedence over another? Neither the statute nor the legislative history resolves this problem, but Treasury regulations do.

Treasury Regulations

On July 1, 1987 the IRS issued temporary regulations for the allocation of interest expense among expenditures.[7] Six months later, on Dec. 21, 1987 the IRS issued temporary regulations regarding qualified residence interest.[8]

Under these regulations, the general rule is that interest on a debt is allocated by tracing disbursement of the debt proceeds to specific expenditures.[9] For example, if the proceeds of a debt are used to make an expenditure in connection with a business, then the interest on the debt will be treated as interest allocable to a business.[10]

However, two sections in these regulations provide that where interest on a debt is qualified residence interest and also is interest described in one of the other excepted categories (such as interest on debt allocable to a business, investment interest, or interest relating to a passive activity), then the interest will be classified as qualified residence interest **first**, and to the extent that such interest **exceeds** the limitations for the deductibility of qualified residence interest, the excess will be deductible (or not) by tracing the use of the proceeds of the debt.[11] For example, in the situation described above, the client would deduct $4,000 of the $10,000 interest on Schedule A because $4,000 is the interest on $100,000 of home equity debt, and $6,000 of the interest on Schedule C.

Several tax practitioners believe that if interest is qualified residence interest and also is interest allocable to a business, then the taxpayer may deduct the interest in whichever category is most advantageous. The tax practitioners believe that the regulations that treat the interest as qualified residence interest first represent an unreasonable interpretation of the statute because the statute doesn't provide a rule that qualified residence interest takes precedence over interest allocable to a business.[12]

However, the IRS and Tax Court disagree. In *Seymour v. Commissioner,*[13] incident to a divorce, the property settlement agreement required the parties to transfer property between them. The property that the husband received was held for multiple purposes including investment, rental, personal residence, and personal property. The property transfers were insufficient to equalize the division of marital assets, so the husband gave the wife a promissory note to make up the difference. The property settlement agreement didn't identify the allocation of the note to any particular assets. Citing Temp. Reg. §1.163-8T(m)(3), the

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Tax Court ruled that the interest paid on the note should first be characterized as qualified residence interest, and afterwards, should be allocated among all the assets that the husband received in accordance with the debt tracing rules.[14]

The Election to Treat the Debt as Not Secured by the Residence

Where interest on a debt is qualified residence interest, a taxpayer may elect to treat the debt as not secured by the qualified residence. [15] The election is made by deducting the interest on the return as business interest or other deductible interest (such as investment interest) rather than as qualified residence interest. [16]

For example, in the situation described above, if the client made this election, then the HELOC would not be treated as secured by her residence. It would not qualify as home equity debt, and thus the debt tracing rules would apply, enabling the client to deduct all of the $10,000 interest on Schedule C.

I have not found any guidance as to **when** the taxpayer must make the election. The regulations are silent on this point; there's nothing to indicate that the election needs to be made on a timely-filed return, and it appears that it may be made at any time as long as the statute of limitations for the return hasn't expired. [17]

There are a few disadvantages to making this election. First, a taxpayer may not make the election for only part of a debt; it applies to the entire debt.[18] Accordingly, if a taxpayer refinances the debt on his or her principal residence and uses the proceeds of the refinance loan to purchase rental property, in the absence of the election, the interest on the debt would be treated as qualified residence interest (allocable partly to acquisition debt and partly to home equity debt) but not as interest on debt allocable to the rental property. If the election were made, the portion of the interest allocable to the residence wouldn't be deductible because the election treats the debt as not secured by the residence. To avoid these results, the taxpayer should obtain a separate loan to purchase the rental property and make the election with respect to this new loan.

Second, the election is binding for the taxable year and for all subsequent taxable years unless revoked with the IRS's consent.[19] As a result, in the situation described above, if the client made the election and subsequently decided to use the same HELOC to borrow additional funds to make improvements to her residence, the interest allocable to the additional borrowed funds wouldn't be deductible because her election treats the debt as not secured by the residence. Again, to avoid this result, the client should obtain a separate HELOC to fund the residential improvements.

Home Equity Debt as Replacement Debt

If the home equity debt replaces old debt that was allocable to a business under the debt tracing rules, then the interest on the home equity debt is not treated as qualified residence interest. This was the situation in *Alexander v. Commissioner*, [20] a non-precedential Tax Court case. In this case, the taxpayer had a tree farm business. Prior to the year involved, he had used credit cards to purchase equipment for use in his tree farm business. The taxpayer obtained a home equity loan secured by his residence and used the proceeds to pay off the credit card debt. He deducted the interest on the home equity loan on Schedule F. The IRS's position was that it was deductible only on Schedule A.

Under the debt tracing rules, the credit card debt was allocable to business expenditures. The home equity loan replaced the credit card debt. The Court noted that under Temp. Reg. §1.163-8T(e)(1), to the extent that proceeds of a replacement debt are used to repay a previous debt, the replacement debt is allocated to the previous debt's expenditures. As a result, since the taxpayer's home equity loan paid off the credit card debt, and since the credit card debt was allocable to business expenditures, the home equity debt was allocated to those expenditures.

Conclusion

Where the proceeds of a home equity debt are used for purposes other than the taxpayer's residence, the rules for deductibility of the interest on that debt are complicated. Since an election exists to treat the debt as not secured by the residence, clients need to seek your advice whenever they plan to obtain such a debt to ensure that the interest will be deductible and will be deductible in the most advantageous location of the return.

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[1] IRC §163(h) as added by the Tax Reform Act of 1986 (P.L. 99-514).

[2] IRC §163(h)(2).

[3] IRC §163(h)(3), as amended by the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203).

[4] IRC §§163(h)(3)(B) and (C).

[5] IRC §163(h)(3)(B)(1).

[6] IRC §163(h)(3)(C).

[7] Temp. Reg. §1.163-8T, issued by T.D. 8145, 1987-2 C.B. 47.

[8] Temp. Reg. §1.163-10T, issued by T.D. 8168, 1988-1 C.B. 80.

[9] Temp. Reg. §1.163-8T(a)(3).

[10] Temp. Reg. §1.163-8T(b)(7).

[11] See Temp. Reg. §1.163-8T(m)(3) ("Qualified residence interest.—Qualified residence interest (within the meaning of section 163(h)(3)) is allowable as a deduction without regard to the manner in which such interest expense is allocated under the [debt tracing] rules of this section.") and Temp. Reg. §1.163-10T(e)(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.").

[12] Recently, the U.S. Supreme Court ruled in Mayo Foundation for Medical Education and Research v. United States, 131 S.Ct. 704 (2011) that an interpretive regulation such as discussed here should be given judicial deference unless it's contrary to the statute, an unreasonable interpretation of the statute, or is arbitrary or capricious.

[13] Seymour v. Commissioner, 109 T.C. 279 (1997).

[14] See also Chief Counsel Advice 201201017 (11/1/2011).

[15] Temp. Reg. §1.163-10T(o)(5).

[16] CCA 201201017.

[17] The IRS approved a late election in Letter Ruling 200932030 under authority of Treas. Reg. §301.9100-3 because there was reasonable cause for not making the election on the original return, but don't think that requesting a letter ruling or making a showing of reasonable cause is necessary.

[18] Temp. Reg. §1.163-10T(o)(5)(i) states that the election is made with respect to "any debt," indicating that it applies to an entire debt, not part of a debt. CCA 201201017 confirms this.

[19] Temp. Reg. §1.163-10T(o)(5)(i).

[20] Alexander v. Commissioner, T.C. Sum. Op. 2006-127.