Mortgage Interest Deduction Allowed, Even Without A Residence

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Section 163(h) of the Code allows a deduction for qualified residence interest. This is interest paid or accrued on acquisition indebtedness with respect to any qualified residence of the taxpayer (or home equity indebtedness), subject to maximum debt limits.

A "qualified residence" is the principal residence of the taxpayer, and one other residence used by the taxpayer as a residence.

In a recent Tax Court case, a taxpayer purchased land, upon which he was going to build a residence. He took out a mortgage loan to buy the property. He then started the design and approval process to build the residence. Two years after, everything was set for construction to begin. However, because of the decline in the real estate market, the taxpayer could not obtain financing for additional funds needed for construction. The house was never built and the taxpayer eventually sold the land (for a large loss).

The taxpayer deducted the interest he paid on the mortgage loan for two years as qualified residence interest. The IRS disallowed the deductions, claiming that there was never a "qualified residence."

The Tax Court sided with the taxpayer and allowed the deduction, even though the residence was never built. The key provision allowing deductibility was Treas.Regs. Section 1.163-10T(p)(5) which allows a taxpayer to treat a residence that is UNDER CONSTRUCTION as a residence for up to 24 months after construction has begun. The Court did not care that the residence was never completed. In effect, it would be illogical for the deduction to be ultimately determined on whether a residence is built, since the deduction that is allowed for the 2 year construction period would have to be taken on a return oftentimes before it is known whether construction will be completed. This would violate the principle that each tax year stands on its own.
The court was also generous with the term "construction." It held that construction began even before the taxpayer acquired the land, since the taxpayer required the seller to demolish an old house on the lot and clear the land before closing. Further, taxpayer's permitting process was also considered to be construction.

*Rose v. Commissioner, T.C. Summary Opinion, 2011-117*

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