Accounting

Ninth Circuit's Voss decision can benefit unmarried taxpayers but be another marriage penalty

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Voss involves unmarried domestic partners registered with the State of California who co-owned real property. Bruce Voss and Charles Sophy, the taxpayers, registered domestic partners, jointly purchased two homes in California and title was vested in both as joint tenants. The total average balance of the two mortgages and the line of credit during the tax years at issue was $2.7 million. Both taxpayers filed separate income tax returns. Each individual claimed home mortgage interest deductions for interest paid on the two mortgages and the home equity line of credit. The IRS calculated each taxpayer's mortgage interest deduction by applying Code Sec. 163. The taxpayers challenged the IRS's calculations but the tax court ruled in favor of the agency.

Under Code Sec. 163, a taxpayer may deduct the interest paid on a mortgage and/or home equity line of credit for a principal residence and a second home. For taxpayers other than married individuals filing a separate return, the deduction is limited to interest paid on $1 million of mortgage debt and $100,000 of home-equity debt. When the taxpayer's home indebtedness exceeds $1 million, the taxpayer is entitled to deduct a portion of the interest determined by the ratio of the statutory debt limit divided by the actual debt. Using this method, the IRS calculated each taxpayer's mortgage interest deduction by applying the limitation ratio to the total amount of mortgage interest each taxpayer paid in each tax year. The tax court affirmed the IRS's determination, concluding that the limitations in Code Sec. 163(h)(3)(B)(ii) and (C)(ii) on the amount that may be treated as acquisition and home-equity indebtedness with respect to a qualified residence applied on a per-residence basis.

However, the appeals court rejected the tax court's reasoning and determined that the Code Sec. 163(h)(3) debt-limit provisions apply on a per-taxpayer basis to unmarried co-owners of a qualified residence.

The text of Code Sec. 163(h) is divided into two key provisions. Those provisions are subsection (B), which provides in pertinent part that "the aggregate amount treated as acquisition indebtedness for any period shall not exceed $1 million ($500,000 in the case of a married individual filing a separate return)," and subsection (C), which states "the aggregate amount treated as home equity indebtedness for any period shall not exceed $100,000 ($50,000 in the case of a separate return by a married individual)." While the statute imposes aggregate limits on those who are married, it fails to express what limits, if any, apply to co-owners who are unmarried. The Ninth Circuit found that Code Sec. 163(h)(3)(B)(ii) and 163(h)(3)(C)(ii) is not completely silent as to one class of co-owners: married couples. The debt limit on acquisitions and the home equity indebtedness each contains parentheticals that impose "half size debt limits" on couples who chose to file separate federal income tax returns. Code Sec. 163(h)(3)(B)(ii) provides: "The aggregate amount treated as acquisition indebtedness for any period shall not exceed $1 million ($500,000 in the case of a married individual filing a separate return)." The parentheticals offer some useful insights. They not only "speak in per-taxpayer terms," but also "operate in a per-taxpayer manner." Moreover, "the very inclusion of the parentheticals suggests that the debt limits apply per taxpayer."

The Ninth Circuit's "per-taxpayer" approach in Voss may give rise to potential planning for lavish vacation properties co-owned by groups of unmarried taxpayers. A group of unmarried taxpayers can purchase and co-own a vacation property. Each of them can take out a mortgage and the mortgage interest deduction will be subject to their own $1.1 million limit.

Because the statute expressly provides that married individuals filing separate returns are entitled to deduct interest on up to $550,000 of home debt each, Congress implied that unmarried co-owners filing separate returns are entitled to deduct interest on up to $1.1 million of home debt each.

The Ninth Circuit's "per-taxpayer" approach in Voss may give rise to potential planning for lavish vacation properties co-owned by groups of unmarried taxpayers. A group of unmarried taxpayers can purchase and co-own a vacation property. Each of them can take out a mortgage and the mortgage interest deduction will be subject to their own $1.1 million limit.

However, this also creates an unfair situation for the married taxpayers. A married couple will have to subject to the $1.1 million limit versus an unmarried couple who literally will be subject to a combined $2.2 million limit.

Unmarried taxpayers in similar situations who live in the Ninth Circuit can take comfort in the notion that the tax court typically follows this ruling. Outside of the Ninth Circuit, however, the tax court may well continue to view the $1.1 million debt limitation rules under Sec. 163(h)(3) on a "per residence basis.

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