Housing Choice Voucher Homeownership Tax Deductibility of Mortgage Interest and Real Estate Taxes

The U.S. Treasury Department and the Internal Revenue Service ("IRS") are authorized to interpret and enforce the provisions of the Internal Revenue Code of 1986 (the "tax code"). This includes the authority to resolve the issue of whether recipients of assistance under the homeownership option in the housing choice voucher program may deduct the amount of mortgage interest and real estate taxes that they have paid on the homes they have purchased. In order to assist in understanding how a program participant may deduct a portion of the mortgage interest and real estate taxes consistent with the guidance provided by the IRS. HUD provides the following summary and explanation. This summary and explanation does not purport to bind the Treasury or the IRS in any way, nor does it purport to bind HUD, as HUD has no authority to interpret or administer the tax code, except in those instances where it has a specific delegation.

The IRS informational letter dated August 28, 2001, advises that recipients under the homeownership option in the housing choice voucher program would probably be prohibited from deducting the full amount of mortgage interest and real estate taxes on the homes they have purchased since the homeownership assistance payments are considered to be general welfare benefits that are not includible in the income of the recipients. Implicit in the IRS information letter is that families participating in the homeownership option may deduct a portion of the mortgage interest and real estate taxes paid during the tax year. A number of public housing agencies (PHAs) have inquired as to how families should calculate the portion of mortgage interest and real estate taxes that may be deducted as a result of the information provided in the IRS letter.

While an information letter is advisory only and has no binding effect on the Internal Revenue Service, it appears that a family could deduct a percentage of the mortgage interest and real estate taxes that is equal to the percentage of the monthly homeownership expenses (as defined by the program) covered by the family (not by the housing assistance payments) during the tax year in question in keeping with the advice proffered by the IRS informational letter. For instance, if the family's monthly homeownership expenses during the tax year were $10,000 and the total housing assistance payments for the year were $3000, it appears from the informational letter that the family could deduct up to 70 percent of the mortgage interest and real estate taxes since the family covered 70 percent of the monthly homeownership expenses defined by the program.

The following examples are offered for illustrative purposes only. Individuals with specific Federal tax questions should contact the Internal Revenue Service directly or consult a tax professional.

Example #1

Assume that over the course of the tax year the applicable payment standard is $900, the family total tenant payment is $600, and the monthly homeownership assistance payment (HAP) is $300. The family's monthly homeownership expenses (as defined in 24 CFR 982.635(c)) equal $1000 per month at the beginning of the tax year and did not change throughout the tax year. The family may deduct up to 70 percent of the interest and real estate taxes on the family Federal tax return.

Total monthly homeownership expenses during tax year	= $12000
minus total HAP paid during tax year	= $ 3600
equals family share of annual homeownership expenses	= $ 8400

Percentage of annual homeownership expenses covered by family = $8400/$12000 = .70

Family may deduct 70 percent of interest and real estate taxes paid for the tax year.

Example #2

1. From January through August the applicable payment standard is $900, the family total tenant payment is $600, the monthly homeownership expenses are $1000. This results in a monthly homeownership assistance payment of $300. The effective date of the family's annual income re-certification is the first of September. September through December the applicable payment standard increased to $930 and the family total tenant payment increased to $700 as a result of an increase in income. As a result the new monthly homeownership assistance payment is $230. Monthly homeownership expenses have increased to $1010 per month.

Total monthly homeownership expenses during tax year ($8000 (Jan - Aug) + $4040 (Sept - Dec))	= $12040
Minus total HAP paid during tax year ($2400 (Jan -Aug) + $920 (Sept -Dec))	= $ 3320
Equals family share of annual homeownership expenses	= $ 8720

$8720/$12040 = .72

Family may deduct 72 percent of interest and real estate taxes paid for the tax year.

Note that monthly homeownership expenses are not simply the monthly mortgage payment (PITI). Monthly homeownership expenses include the principal and interest on initial mortgage debt, any refinancing of such debt, and any mortgage insurance premium incurred to finance purchase of the home; real estate taxes and public assessments on the home; home insurance; the PHA allowance for maintenance expenses; the PHA allowance for costs of major repairs and replacements; the PHA utility allowance for the home; principal and interest on mortgage debt incurred to finance costs for major repairs, replacements, or improvements for the home (which may include debt incurred by the family needed to make the home accessible for a family member with disabilities if the PHA determines allowance of such costs is needed as a reasonable accommodation); and land lease payments (where a family does not own fee title to the real property on which the home is located in accordance with the requirements of §982.628(b)). See 24 CFR 982.635(c).

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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CC:ITA:1:KDavidson
COR-132693-01

Jerry Gross, Senior Tax Attorney
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U.S. Department of Housing and Urban Development
Washington, D.C. 20410-0500

Dear Mr. Gross:

This letter responds to your letter of June 11, 2001, inquiring whether recipients of assistance under the Section 8 Homeownership Program may deduct the full amount of mortgage interest and real estate taxes on the homes they have purchased. This letter is an "information letter" as defined in section 2.04 of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 8. An information letter is advisory only and has no binding effect on the Internal Revenue Service. Section 2.04 of Rev. Proc. 2001-1.

As we understand the facts, Section 8 tenant-based voucher homeownership assistance is authorized by §§ 8(o)(15) and 8(y) of the United States Housing Act of 1937, as amended (42 U.S.C. § 1437 *et seq.*). The homeownership assistance may be in the form of monthly homeownership assistance or, subject to appropriations, a one-time downpayment grant. The tenant-based voucher program is administered by local public housing agencies (PHAs). HUD provides federal funds to the PHA, which in turn, provides monthly housing assistance payments to (1) the owner of the rental housing unit occupied by the section 8 participant family or (2) in the case of the homeownership option, directly to the family or to the lender on behalf of the family.

Section 163(a) of the Internal Revenue Code generally allows a deduction for all interest paid or accrued within the taxable year on indebtedness. Section 163(h)(2)(D) provides taxpayers may deduct qualified residence interest. "Qualified residence interest" includes interest paid or accrued during the taxable year on acquisition indebtedness which is incurred with respect to any "qualified residence" of the taxpayer (the principal residence of the taxpayer). Section 163(h)(3)(A). "Acquisition indebtedness" means any indebtedness which is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer and is secured by the residence. Section 163(h)(3)(B).

COR-132693-01

Section 164(a)(1) provides taxpayers may deduct state, local, and foreign real property taxes for the taxable year within which paid or accrued. Section 1.164-3(b) of the Income Tax Regulations defines real property taxes, in part, as taxes imposed on real property and levied for the general public welfare.

Your letter states that Section 8 homeownership assistance payments are considered to be general welfare benefits that are not includible in the income of the recipients. Because Section 8 homeownership assistance payments are exempt from tax as general welfare payments, the issue is whether taxpayers receiving the assistance may deduct their mortgage interest and property tax payments under §§ 163(h)(2)(D) and 164(a)(1), or whether those deductions are prohibited by § 265. Section 265(a)(1) provides no deduction shall be allowed for any amount otherwise allowable as a deduction which is allocable to one or more classes of income which is wholly exempt from taxes. Section 1.265-1(b)(1) broadly defines exempt income as any class of income (whether or not any amount of income of such class is received or accrued) wholly exempt from the taxes imposed by subtitle A of the Internal Revenue Code.

Although § 265(a)(1) is most commonly applied to prevent the deduction of expenses incurred in the course of earning tax-exempt income, § 265(a)(1) has been applied to prohibit deduction of expenses paid by taxpayers that were allocable to tax-free allowances. For example, in Rev. Rul. 83-3, 1983-1 C.B. 72, the Service denied deductions for expenses paid by taxpayers that were allocable to tax-free veterans' benefits, parsonage allowances, and scholarships received by the taxpayers. The ruling analyzed § 265(a)(1) and its underlying case law and stated as follows:

> The purpose of section 265 of the Code is to prevent a double tax benefit. In *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969), 1969-1 C.B. 204, the Supreme Court of the United States said that the Internal Revenue Code should not be interpreted to allow the practical equivalence of double deductions absent clear declaration of intent by Congress. Section 265(1) applies to otherwise deductible expenses incurred for the purpose of earning or otherwise producing tax exempt income. It also applies where tax exempt income is earmarked for a specific purpose and deductions are incurred in carrying out that purposes. In such event, it is proper to conclude that some or all of the deductions are allocable to the tax exempt income.

In the situation involving the parsonage allowance received by a minister, the Service determined that § 265(1)(1) prevented the deduction of the minister's mortgage interest and real estate taxes. Because the minister's interest and taxes were paid to house him, they were allocable to the parsonage allowance that was received by him. Further, because the parsonage allowance was tax exempt, permitting the minister to deduct

interest and tax payments allocable to the parsonage allowance would lead to a double benefit. The ruling concluded the minister could deduct only the amount remaining after subtracting the portion of his interest and tax payments equal to his parsonage allowance over his total housing expenses. In 1986, Rev. Rul. 83-3 was revoked by Rev. Rul. 87-32, 1987-1 C.B. 131, which was issued in reaction to the enactment of § 265(a)(6) allowing recipients of parsonage and military housing allowances to deduct mortgage interest and taxes. Other types of housing allowances, however, remain within the ambit of § 265(a)(1).

In *Induni v. Commissioner*, 990 F.2d 53 (2d Cir. 1993), the taxpayers, employees of the U.S. Immigration and Naturalization Service working in Montreal, received tax exempt housing stipends of a type provided to federal employees stationed abroad who are not otherwise provided with housing. The taxpayers purchased a house in Montreal and attempted to deduct mortgage interest and tax payments. The Service denied their deductions on grounds the deductions were allocable to their tax exempt stipend. The Tax Court held for the Service and, on appeal, the taxpayers argued that, notwithstanding § 265(a)(1), the Service had a longstanding practice of permitting recipients of housing stipends to deduct mortgage interest and tax payments and that this practice was affirmed by the 1986 amendment to § 265 permitting recipients of military housing allowances and parsonage allowances to nevertheless deduct mortgage interest and tax payments.

The Second Circuit reviewed the Service's rulings and found the Service had taken an expansive view of the application of § 265(a)(1) to housing stipends, scholarships, etc. The Second Circuit determined that the 1986 amendment permitting deductions of expenses incurred only by recipients of military and parsonage allowances and not by all groups of taxpayers who enjoy tax exempt housing allowances, implies that all other tax exempt housing allowances are within the ambit of § 265(a)(1).

Thus, *Induni* affirms the Service's long term policy of expansive application of § 265(a)(1) to housing stipends, scholarships, etc. Under this policy, § 265(a)(1) would probably be viewed as prohibiting the recipients of assistance under the Section 8 Homeownership Program from deducting the full amount of mortgage interest and real estate taxes on the homes they have purchased.

COR-132693-01

We hope this general information is helpful. For more specific guidance, a taxpayer may request a private letter ruling from the national office of the Internal Revenue Service. We have enclosed a copy of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, which contains the procedures for a taxpayer to request a private letter ruling. If we can be of further assistance to you regarding this matter, please feel free to contact Kelly Davidson (ID # 50-15274) of the Income Tax and Accounting Division on (202) 622-5020.

Sincerely,

Paul M. Ritenour/KLK

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Associate Chief Counsel
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Enclosure:
Rev. Proc. 2001-1