NO PASS-THROUGH OF INTEREST FROM HOMEOWNERS ASSOCIATION

By Gary A. Porter, CPA

In Private Letter Ruling 200029018, the Internal Revenue Service (IRS) addressed the issue of what qualifies as "qualified residence interest" as related to a homeowners association and member/taxpayer. The facts set forth in the Private Letter Ruling are somewhat unusual, but the overall situation is not all that uncommon. In this particular case, the local county condemned the association buildings. This required that the association borrow money to demolish and rebuild the association buildings. They planned to pay for this by collecting special assessments from members to service the mortgage. We are much more familiar with the scenario wherein an association's property is destroyed by a natural disaster such as an earthquake or hurricane. But, the net results are the same in that association must, after receiving any insurance proceeds, borrow money or make special assessments to rebuild the common area properties.

"The Northridge, California earthquake of 1994 caused widespread damage and caused many associations to borrow monies to make all necessary repairs. Consequently, the deductibility of interest by the individual members of an association is a question that has arisen frequently in recent years. This ruling analyzes the law and sets forth the guidelines for deductibility of interest."

In the facts set forth in the private letter ruling, the association did borrow the money under the association's name. The collateral for the loan consisted of the regular and special assessments of the homeowners, a Deed of Trust on the common elements, and assignment of homeowners' dues. It is important to note the individual member's (the taxpayer) home was not pledged as collateral on the loan.

The law and analysis that set forth in the Private Letter Ruling is:

> Section 163(a) of the Internal Revenue Code provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.
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> Section 163(h)(1) of the Code provides in part that in the case of a taxpayer other than a corporation, no deduction shall be allowed for personal interest paid or accrued during the taxable year.
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> Section 163(h)(2) of the Code provides in part that for purposes of this subsection, the term "personal interest" means any interest allowable as a deduction other than any qualified residence interest.
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> Section 163(h)(3) of the Code provides in part that the term "qualified residence interest" means any interest which is paid or accrued during the taxable year on acquisition indebtedness with respect to any qualified residence of the taxpayer. "Acquisition indebtedness" is defined in the section as any indebtedness which is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and is secured by such residence.

Section 1.163-10T(o) of the Temporary Income Tax Regulations provides that "secured debt" means a debt that is on the security of any instrument (such as a mortgage, deed of trust, or land contract):

> i) that makes the interest of the debtor in the qualified residence specific security for the payment of the debt,
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> ii) under which, in the event of default, the residence could be subjected to the satisfaction of the debt with the same priority as a mortgage or a deed of trust in the jurisdiction in which the property is situated, and
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> iii) that is recorded, where permitted, or is otherwise perfected in accordance with applicable state law.

Section 1.163-10T(o) also provides that a debt will not be considered to be secured by a qualified residence if it is secured solely by virtue of a lien upon the general assets of the taxpayer, or by a security interest, such as a mechanic's lien or judgment lien, that attaches to the property without the consent of the debtor.

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> Section 1.163-10T(p) of the Regulations provides in part that the term "qualified residence" means the taxpayer's principal residence within the meaning of former Code section 1034 . Section 1.163-10T(p)(ii) provides that whether property is a residence shall be determined based on all the facts and circumstances, including good faith of the taxpayer. A residence generally includes a house, condominium, mobile home, boat, or house trailer, that contains sleeping space and toilet and cooking facilities.

Through the above analysis, the IRS determined that the person entitled to deduct interest is the person who is legally liable to pay the interest. In this case, the association is the borrower on the loan and is the entity responsible for paying the interest. Further, the individual member, the taxpayer, had not undertaken any personal contractual obligation with the bank as a primary obligor on the loan. Also, the taxpayer's personal residence was not specific security for the loan. Therefore the individual taxpayer did not satisfy the requirements for deduction of home mortgage interest under IRC Section 163(h). The IRS therefore concluded that the association is entitled to the interest deduction and the individual member is not entitled to such deduction.

The Northridge, California earthquake of 1994 caused widespread damage and caused many associations to borrow monies to make all necessary repairs. Consequently, the deductibility of interest by the individual members of an association is a question that has arisen frequently in recent years. This ruling analyzes the law and sets forth the guidelines for deductibility of interest.

CPAs should be aware of these issues when advising associations on the structuring of debt. If there is any intent by the association to pass through interest as a deduction to its members.

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