Family Home Loan Interest May Not Be Deductible

Article Highlights:

- Qualified residence interest is deductible interest paid or accrued during the tax year on acquisition indebtedness or home equity indebtedness with respect to any qualified residence of the taxpayer.
- Acquisition indebtedness means any indebtedness that is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and is secured by such residence.
- Interest on unsecured home debt is generally not deductible.

It is not uncommon for individuals to loan money to relatives to help them buy a home. In these situations, it is also not uncommon for a loan to be undocumented or documented by an unsecured note, with the unintended result that the home buyer can't claim a tax deduction for the interest paid to their helpful relative.

The tax code describes qualified residence interest as interest paid or accrued during the tax year on acquisition indebtedness or home equity indebtedness with respect to any qualified residence of the taxpayer. It also provides that the term "acquisition indebtedness" means any indebtedness that is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, **and is secured by such residence**. There are also limits on the amount of debt and number of qualified residences a taxpayer may have for purposes of claiming a home mortgage interest tax deduction, but those details are not covered in this article, which is focusing on the requirement that the debt be secured.

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 of the payment of the debt,

(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 deed of trust in the jurisdiction in which the property is situated, and

(iii) that is recorded, where permitted, or is otherwise perfected in accordance with applicable state law.

In other words, the home is put up as collateral to protect the interest of the lender.

Thus interest paid on undocumented loans, or documented but unsecured notes, is not deductible by the borrower but is fully taxable to the lending individual. The IRS is always skeptical of family transactions. Don't get trapped in this type of situation; take the time to have a note drawn up and recorded or perfected in accordance to state law.

If you have questions related to this situation or other issues related to the deductibility of home mortgage interest, please give this office a call.