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Tax Court Addresses Real Estate Interest Deductions

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The federal income tax treatment of interest deductions is often complex and unintuitive. A recent Tax Court case addressed a number of issues that may be relevant for taxpayers with interest expense on debt attributable to real estate activities.

Cardulla v. Commissioner, T.C. Memo 2023-89, involved a *pro se* taxpayer who had a number of real estate investments. In particular, in 2006, a single-member LLC owned by the taxpayer had acquired vacant land along the Salton Sea in California in exchange for a 12-year $1,200,000 note secured by a mortgage on the property. The note provided for 10% simple interest per annum, but did not require any payments of interest or principal until the maturity date. The taxpayer did not rent out or develop the property, although he did receive $5,000 per year from a fish farm for an easement permitting wastewater to pass through part of the property.

When the amount payable at maturity under a debt instrument exceeds the amount for which it was issued, the excess is referred to as original issue discount (OID) and is taxed as interest. For example, if a debt instrument was issued for $100 and bears no interest but pays $110 at maturity, the $10 of OID is taxed as interest. Similarly, if a debt instrument has interest that is not mandatorily payable at least annually, then the debt instrument is generally treated as having OID in an amount equal to the total payments due under the note (other than such mandatorily payable interest) minus the issue price.

If a note has OID, then the taxpayer must determine a hypothetical yield to maturity (i.e., the overall compounded interest rate earned by the lender) for which the present value of the payments under the note equals the note's issue price, and allocate the OID to each year in accordance with that yield. Each year, the lender must include in income its share of the OID for such year, and the borrower is allowed a corresponding deduction. The OID must be included in income or deducted in the year in which it accrues, regardless of when it is paid, even if the taxpayer is on the cash-basis method of accounting.

In this case, because the note provided that interest was not mandatorily payable until maturity, the note was treated as having OID, and the taxpayer should have deducted the OID in the years to which the OID was allocable. However, the taxpayer was unaware of the OID rules, and on his tax returns, he simply claimed a $120,000 interest deduction each year, on the rationale that his business was on the accrual method of accounting and this was the amount of simple interest that accrued under the note.

For the years at issue in the case, deducting the proper amount of OID would have resulted in higher interest deductions than the taxpayer actually took. However, the Tax Court held that by deducting the accrued simple interest in prior years, the taxpayer had adopted a method of accounting, and the taxpayer was not permitted to change this method of accounting without the consent of the IRS. The taxpayer was therefore stuck with smaller interest deductions for these later years.

Applicable regulations provide that a taxpayer cannot change a method of accounting, even an incorrect one, without the consent of the IRS. However, it was not clear that this overrides the OID rules, which usually apply notwithstanding a taxpayer's method of accounting. The Tax Court's opinion was therefore surprising and somewhat unfair to the taxpayer, and illustrates the perils of ignoring the OID rules.

A second important issue raised by this case concerned the character of the interest deductions. An individual taxpayer's interest expense must be fit into one of several categories. Interest that is allocable to a trade or business is considered "business interest" and is generally deductible, subject to certain limitations. Interest that is allocable to property held for investment is considered "investment interest" and can generally only be used to offset a taxpayer's investment income. Interest that is allocable to a passive activity (which includes most rental activities) is considered a passive activity loss, which can only offset income from a passive activity. Finally, interest that does not fit into any of the above categories is generally considered "personal interest," and is not deductible at all. Interest expense is allocated among these categories based on how the proceeds of the underlying debt are used.

In this case, the interest at issue related to debt that was used to acquire the undeveloped real estate. The taxpayer had argued that the real estate constituted a trade or business. However, the Tax Court held that the taxpayer's activities with respect to the real estate did not amount to a trade or business, because he never developed the property and received only a minimal amount of income attributable to the fish farm easement. Moreover, the court found that the taxpayer's primary motivation for holding the property was for appreciation rather than for rental income. The IRS did not argue that the interest expense constituted a passive activity loss, presumably because it did not consider the property to be a rental activity. The court therefore held that the interest constituted investment interest, even though the court noted that these facts were a "poor fit" under the applicable statutory definitions. Thus, the interest could only be deducted to the extent of the taxpayer's investment income.

In sum, this case illustrates that many issues can arise with respect to the taxation of interest expense, even on seemingly simple debt instruments. Taxpayers must be careful to ensure that their interest expense has the intended tax treatment, particularly when it relates to real estate activities that might not rise to the level of a trade or business.

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