

Appendix B. Internal Tax Memo from Spilker et al.

EXHIBIT 2-9 Sample Internal Research Memo

Below is the memo Bill and Mercedes's CPA drafted after researching their issue.

Date: July 8, 2021
Preparer: Joe Staff
Reviewer: Sandra Miller
Subject: Deductibility of Points Paid in Refinancing
Facts: Four years ago Bill and Mercedes's credit union provided them a \$250,000 mortgage loan for their new home. The mortgage loan was a four-year interest-only note with a balloon payment at the end of four years. Bill and Mercedes (Floridians residing in the 11th Circuit) chose this type of loan to allow them to minimize their mortgage payment until their other house was sold. After 18 months, Bill and Mercedes sold their other house and refinanced their original short-term loan with a 15-year conventional mortgage. The credit union charged Bill and Mercedes \$3,000 in points (prepaid interest) upon the refinancing.
Issue: Can Bill and Mercedes deduct the points in the year they paid them?
Authorities: §461(g).
Rev. Rul. 87-22, 1987-1 C.B. 146.
J.R. Huntsman v. Comm'r, 90-2 USTC par. 50,340 (8th Cir. 1990), *rev'g* 91 TC 917 (1988).
AOD 1991-002.
P.G. Cao v. Comm'r, 96-1 USTC par. 50,167 (9th Cir. 1996), *aff'g* 67 TCM 2171 (1994).

Conclusion: Because Bill and Mercedes's refinancing represents an integrated step in securing permanent financing for their home, substantial authority supports their deduction of the \$3,000 in points this year.

Analysis: §461(g)(1) provides that cash-method taxpayers (Bill and Mercedes) must amortize prepaid interest (points) over the life of the loan instead of receiving a current deduction. §461(g)(2) provides an exception to the general rule of §461(g)(1). Specifically, §461(g)(2) allows cash-method taxpayers to deduct points in the year paid if the related debt was incurred "in connection with the purchase or improvement of," and secured by, the taxpayer's principal residence. The question whether Bill and Mercedes should amortize or currently deduct the points paid to refinance the mortgage on their principal residence depends upon the interpretation of "in connection with the purchase or improvement of" found in §461(g)(2).

There are two basic interpretations of "in connection with the purchase or improvement of." In Revenue Ruling 87-22, the IRS rules that points incurred in refinancing a mortgage on a taxpayer's residence are deductible in the year paid to the extent that the taxpayer uses the loan proceeds to improve the taxpayer's residence. Thus, points paid to simply refinance an existing mortgage without improving the residence must be amortized over the life of the loan.

In contrast, in *J.R. Huntsman v. Comm'r*, the 8th Circuit Court interpreted the phrase "in connection with the purchase or improvement of" much more broadly and held that points incurred to refinance a mortgage on the taxpayer's principal residence are currently deductible if the refinancing represents an *integrated step to secure permanent financing* for the taxpayer's residence. The facts in *J.R. Huntsman v. Comm'r* are very similar to Bill and Mercedes's facts. Like Bill and Mercedes, the taxpayers in *J.R. Huntsman v. Comm'r* also purchased their principal residence using a short-term loan with a "balloon" payment. When the balloon payment came due, the taxpayers obtained a permanent mortgage on their home (a 30-year conventional mortgage). The 8th Circuit Court held that in this case the permanent mortgage was acquired to extinguish the short-term financing and finalize the purchase of the home. "Thus, where taxpayers purchase a principal residence with a short-term three-year loan secured by a mortgage on the residence, and replace the loan with permanent financing . . . , the permanent mortgage obtained is sufficiently in connection with the purchase of the home to fall within the exception provided for by section 461(g)(2)." In Action on Decision 1991-002, the IRS has indicated that it will not follow the *J.R. Huntsman v. Comm'r* decision outside the 8th Circuit (in the 11th Circuit where Bill and Mercedes live). Nonetheless, other courts (the 9th Circuit in *P.G. Cao v. Comm'r*) have indicated a willingness to apply the 8th Circuit's interpretation of §461(g)(2). That is, they have allowed deductibility of points incurred in refinancing if the refinancing occurred to secure permanent financing, instead of for some other reason such as to secure a lower interest rate.

Given the similarity in facts between Bill and Mercedes's refinancing and those in *J.R. Huntsman v. Comm'r* (refinancing of a short-term note to secure permanent financing), substantial authority supports a current deduction of the points paid.