DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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CC:ITA:1:KDavidson
COR-132693-01

Jerry Gross, Senior Tax Attorney
Office of the General Counsel
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).

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.

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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

Paul M. Ritenour
Chief, Branch 1
Associate Chief Counsel
(Income Tax and Accounting)

Enclosure:
Rev. Proc. 2001-1