



## Home Equity of A Different Sort—Claiming Deductions for a Home the Taxpayer Doesn't Own



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## Equitable Ownership and Residences

This week we look at issues raised in the case of *Nair v. Commissioner*, TC Summary Opinion 2007-116. Mr. Nair was attempting to claim a deduction for home mortgage interest and property taxes on a property that he was not listed as the owner of, nor the person obligated on the mortgage, as well as a deduction for a casualty loss from a fire that occurred at the residence. We'll look at why Mr. Nair did not prevail, as well as what facts might have existed that would have allowed him to claim the deduction.

## Home Expenses

The IRC grants a number of breaks to homeowners, including the ability to deduct interest on the mortgage to acquire the home (Section 163(h)(2) and (3)) and the property taxes paid on the property (under Section 164 the latter being available on any real

estate—but we digress). As well, if a homeowner experiences a casualty loss on the home that is not reimbursed by insurance, the taxpayer can claim a deduction for the casualty loss (Section 165(a)), subject to the AGI limitations and \$100 floor.

Mr. Nair claimed deductions for all of these on his personal return for the year in question, in the amount of \$2,459 for real estate taxes, \$4,418 in home mortgage interest and \$27,927 for a casualty loss. However, Mr. Nair himself was not listed as an owner of the house—rather it was titled in the name of his father and an unrelated individual. As well, Mr. Nair was not named on the mortgage—that named his father and mother as the individuals who owed the mortgage. Mr. Nair made at least some of the mortgage payments on the property during the year in question, establishing that fact from his bank account.

As well, the property suffered a major fire on February 25, 2003, 19 days after the insurance policy on the home was cancelled due to nonpayment of the insurance premium—so it created an uninsured loss to the property. Mr. Nair claimed a loss of \$26,000 on the home (the basis he claimed existed, with the property worth \$112,350 before the fire) and \$6,500 for personal property for which he claimed a basis of \$7,500.

The IRS argued that this was all fine and good—but as Mr. Nair was not the owner of the property none of these expenses were deductible by Mr. Nair, even if he had paid them. The IRS also argued that the casualty losses were not deductible, even for the personal property, because Mr. Nair had not established evidence of his basis in the items in question. The Tax Court agreed with the IRS. But, as the court noted, the mere fact that Mr. Nair was not listed on the title for the property was not, by itself, enough to settle the matter.

## **Beneficial Ownership**

The regulations under §163 generally require that a taxpayer be the owner of the property in order to deduct the interest on the mortgage. However, the regulations do recognize equitable ownership at Reg. §1.163-1(b) which provides:

(b) Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or *equitable owner*, even though the taxpayer is *not directly liable upon the bond or note* secured by such mortgage, may be deducted as interest on his indebtedness...

The Tax Court notes that the question of whether Mr. Nair was the equitable owner of the property is a matter that is decided under state law. The court notes:

State law determines the nature of property rights, and Federal law determines the tax consequences of those rights. *United States v. Natl. Bank of Commerce*, 472 U.S. 713, 722 (1985); *Blanche v. Commissioner*, T.C. Memo. 2001-63, affd. 33 Fed. Appx. 704 (5th Cir. 2002). Under New York law, a purchaser of property

becomes the equitable owner upon entering into a contract for sale of the property. *Dubbs v. Stribling & Associates*, 712 N.Y.S.2d 19 (App. Div. 2000), affd. 752 N.E.2d 850 (2001); *Edwards v. Van Skiver*, 681 N.Y.S.2d 893 (App. Div. 1998).

The court noted that Mr. Nair did not offer any evidence that he had entered into agreement with his father or the other owner on the title of the house that would have granted him an ownership interest.

The Tax Court noted that in two cases it had held that the taxpayer's relatives acquired the mortgage as an accommodation to the taxpayer that the taxpayer was allowed to deduct the home mortgage interest, citing the cases of *Trans v. Commissioner*, TC Memo 1999-233 and *Uslu v. Commissioner*, TC Memo 1997-551. The court notes:

urthermore, petitioner's situation is not similar to cases where we have held that even though the taxpayer's family member secured the mortgage as an accommodation, the deduction was appropriate because the taxpayer exclusively had, and was intended to have, the benefits and burdens of ownership. See *Trans v. Commissioner*, supra; *Uslu v. Commissioner*, supra. In *Trans* and *Uslu*, the taxpayers lived in the houses, made all of the mortgage payments, and paid all other expenses for maintenance and improvements. In addition, the taxpayers in *Trans* made the downpayment on the purchase.

But, the court notes, Mr. Nair's situation is not similar.

In the present case, petitioner has not offered evidence that the benefits and burdens he had from the Bronx Boulevard house rose to the level accepted by this Court in *Uslu* and *Trans*. Petitioner stated that he made payments related to the house on behalf of his parents, whom he testified were his dependents and had no bank accounts. Petitioner's bank statements show that he made only eight mortgage payments, none before May 2003. Petitioner did not claim he contributed to the downpayment on the house. We have no evidence to support petitioner's claim that he paid the premiums on the insurance policy covering the house. The record is also unclear as to what extent petitioner even lived in the house. Overall, we cannot say that petitioner's actions with respect to the house indicate that he treated the house as his own or that he was intended to have the full benefits and burdens of ownership.

Note that his payments on the mortgage did not begin until after the uninsured fire had effectively destroyed the property and, given the fact that the insurance was cancelled for failure to pay premiums, likely because his parents simply could not afford now to continue to make mortgage payments on a severely damaged residence since they had to obtain another place to live. In fact the court notes:

We conclude based on the record that petitioner made payments on his parents' mortgage merely as a way to provide support for them. While admirable, this moral obligation to support his parents does not entitle him to deduct the mortgage interest. See *Daya v. Commissioner*, supra; *Tuer v. Commissioner*, T.C. Memo. 1983-441.

## Real Estate Taxes

Real estate taxes are allowed as deduction under §164(a)(1) which provides:

(a) General rule

Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

(1) State and local, and foreign, real property taxes

However, Reg. §1.164-1(a) provides in part that “in general, taxes are deductible only by the person upon whom they are imposed” and, as you might expect, those taxes are imposed on the owner of the property.

The court notes, though, that the same equitable ownership exception applies to property taxes:

As with mortgage interest, we have held that taxpayers who do not have legal title to property may nevertheless deduct property taxes paid with respect to the property if they establish equitable ownership of the property. See *Trans v. Commissioner*, supra; *Uslu v. Commissioner*, supra.

Of course, since the court had already decided Mr. Nair was not the equitable owner, it is no surprise that the court also decided there was no basis for him to claim these taxes as deductible on his return.

## Casualty Losses

Casualty losses are allowed as a deduction under §165. Section 165(a) through (c) provides:

(a) General rule

There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of deduction

For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Limitation on losses of individuals

In the case of an individual, the deduction under subsection (a) shall be limited to--

- (1) losses incurred in a trade or business;
- (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
- (3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

The general rule of §165(a), though for an individual the items that can be deducted under §165 are limited to those that fall into three categories. As well, note that under §165(b) one of the key items that is used to compute the loss is the adjusted basis of the asset in question.

Special rules for casualty losses of individuals are found at §165(h):

(h) Treatment of casualty gains and losses

(1) \$100 limitation per casualty

Any loss of an individual described in subsection (c)(3) shall be allowed only to the extent that the amount of the loss to such individual arising from each casualty, or from each theft, exceeds \$100.

(2) Net casualty loss allowed only to the extent it exceeds 10 percent of adjusted gross income

(A) In general

If the personal casualty losses for any taxable year exceed the personal casualty gains for such taxable year, such losses shall be allowed for the taxable year only to the extent of the sum of--

- (i) the amount of the personal casualty gains for the taxable year, plus
- (ii) so much of such excess as exceeds 10 percent of the adjusted gross income of the individual.

(B) Special rule where personal casualty gains exceed personal casualty losses

If the personal casualty gains for any taxable year exceed the personal casualty losses for such taxable year--

- (i) all such gains shall be treated as gains from sales or exchanges of capital assets, and

(ii) all such losses shall be treated as losses from sales or exchanges of capital assets.

(3) Definitions of personal casualty gain and personal casualty loss

For purposes of this subsection--

(A) Personal casualty gain

The term "personal casualty gain" means the recognized gain from any involuntary conversion of property which is described in subsection (c)(3) arising from fire, storm, shipwreck, or other casualty, or from theft.

(B) Personal casualty loss

The term "personal casualty loss" means any loss described in subsection (c)(3). For purposes of paragraph (2), the amount of any personal casualty loss shall be determined after the application of paragraph (1).

(4) Special rules

(A) Personal casualty losses allowable in computing adjusted gross income to the extent of personal casualty gains

In any case to which paragraph (2)(A) applies, the deduction for personal casualty losses for any taxable year shall be treated as a deduction allowable in computing adjusted gross income to the extent such losses do not exceed the personal casualty gains for the taxable year.

(B) Joint returns

For purposes of this subsection, a husband and wife making a joint return for the taxable year shall be treated as 1 individual.

(C) Determination of adjusted gross income in case of estates and trusts

For purposes of paragraph (2), the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that the deductions for costs paid or incurred in connection with the administration of the estate or trust shall be treated as allowable in arriving at adjusted gross income.

(D) Coordination with estate tax

No loss described in subsection (c)(3) shall be allowed if, at the time of filing the return, such loss has been claimed for estate tax purposes in the estate tax return.

(E) Claim required to be filed in certain cases

Any loss of an individual described in subsection (c)(3) to the extent covered by insurance shall be taken into account under this section only if the individual files a timely insurance claim with respect to such loss.

Mr. Nair's issues, however, really didn't involve §165(h)'s limitations, as his problems were more basic. With regard to the real estate, Mr. Nair again faced the problem that he didn't own the property, as the court noted:

Inherent in section 165 is the requirement that to claim a deduction for the loss of property, the taxpayer must have been the owner of the property at the time of the loss. *Draper v. Commissioner*, 15 T.C. 135 (1950); *Miller v. Commissioner*, T.C. Memo. 1975-110. If the taxpayer is not the owner of the property, the taxpayer generally cannot claim a deduction for a casualty loss relating to that property. *Blanche v. Commissioner*, T.C. Memo. 2001-63; see *Wayno v. Commissioner*, T.C. Memo. 1992-53, affd. without published opinion 12 F.3d 1111 (9th Cir. 1993). In our discussion regarding the mortgage interest deduction, we held that petitioner had no legal or equitable ownership interest in the Bronx Boulevard house during 2003 when the fire loss occurred.

Therefore it's not surprising he has a problem—but the court noted another problem that also would have blocked the deduction even if he had been the owner. Mr. Nair failed to establish the basis of the house:

In addition, in order to determine entitlement to a casualty loss deduction, a taxpayer's basis in the damaged or destroyed property must be known. Where a taxpayer fails to prove his basis, we are unable to determine the amount of loss that is deductible. *Zmuda v. Commissioner*, 79 T.C. 714, 727 (1982), affd. 731 F.2d 1417 (9th Cir. 1984); *Millsap v. Commissioner*, 46 T.C. 751, 760 (1966), affd. on other issues 387 F.2d 420 (8th Cir. 1968); see, e.g., sec. 1.165-1(c), Income Tax Regs. Petitioner has not proven any tax basis in the Bronx Boulevard house.

This issue would serve to also eliminate the deduction for the loss of items that Mr. Nair apparently did own—personal property that might have been destroyed in the fire:

Turning to petitioner's personal property allegedly destroyed in the Bronx Boulevard house fire, petitioner has not adequately proven entitlement to this deduction. The only documentation he provided for this loss was a list of property allegedly destroyed along with dollar amounts representing the value petitioner assigned to each item. This list neither substantiates the loss of the personal property, nor establishes petitioner's tax basis in the property. We therefore hold that petitioner may not deduct any amount for the loss of personal property in the Bronx Boulevard house fire.

So Mr. Nair struck out on all of his deductions, and the IRS prevailed entirely in the case.

## **Lessons**

This particular case is mainly one of a *pro se* taxpayer who was attempting to defend a position that had no chance whatsoever—not an abnormal occurrence in the summary cases.

But the case is of interest more for the court's discussion of how a different set of facts would have resulted in Mr. Nair obtaining the benefits even though he was not on the title or the mortgage for the property. As well, it serves as a reminder of the issue (and, frankly, problem) of proving basis in a casualty loss situation. So even in what is, ultimately, a very simple cut and dried case that most of us could predicted the ultimate result for after a minute looking at the facts Mr. Nair had, there's still some useful references contained in the opinion of the case.