

**Internal Revenue Service**

Department of the Treasury

Washington, DC 20224

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[Redacted]

Person to Contact:  
Kim Koch / Badge No. 50-04024  
Telephone Number:  
(202) 622-4950  
Refer Reply To:  
CC:ITA:5 COR-114627-01  
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[Redacted]

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**LEGEND:**

Taxpayer = [Redacted]  
Bank = [Redacted]  
Property = [Redacted]

[Redacted]

This letter responds to Taxpayer's request for a private letter ruling dated October 5, 1999. Specifically, Taxpayer requests the following rulings: (1) that certain amounts payable under a home financing arrangement are deductible by Taxpayer as qualified residence interest under § 163(h) of the Internal Revenue Code; and (2) that certain real estate taxes are deductible by Taxpayer under § 164(a)(1).

Taxpayer's ruling requests require an initial factual determination of whether Taxpayer is the true owner of the underlying property to which the "interest" and real estate taxes relate. Section 7.01 of Rev. Proc. 99-1, 1999-1 I.R.B. 3, provides that the Internal Revenue Service ordinarily will not issue letter rulings or determination letters in certain areas because of the factual nature of the problem involved or because of other reasons. Section 4.01(3) of Rev. Proc. 99-3, 1999-1 I.R.B. 103, provides that the Service will not ordinarily issue rulings or determination letters as to who is the true owner of property or the true borrower of money in cases in which the formal ownership of the property, or the liability for the indebtedness, is in another party.

Section 7.01 of Rev. Proc. 99-1 provides that, instead of issuing a letter ruling or determination letter, the national office or a district director may, when it is considered appropriate and in the best interests of the Service, issue an information letter calling attention to well-established principles of tax law. Section 2.04 of Rev. Proc. 99-1 provides that an "information letter" is a statement issued by the national office or by a

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district director. It calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. An information letter may be issued if the taxpayer's inquiry indicates a need for general information or if the taxpayer's request does not meet the requirements of Rev. Proc. 99-1 and the Service thinks general information will help the taxpayer. An information letter is advisory only and has no binding effect on the Service. In this case, because Taxpayer's ruling requests require an initial factual determination on which the Service ordinarily does not rule, we are issuing an information letter rather than a letter ruling. We will refund Taxpayer's user fee in a separate correspondence.

### FACTS

Bank financed the purchase of a single-family private residence (the "Property") for Taxpayer, who abides by religious principle against the borrowing of money on which interest is charged. Taxpayer entered into a contract for the purchase of the Property and placed a down payment toward the purchase. However, due to religious restrictions, Taxpayer was unable to enter into a home mortgage for the remainder of the purchase price. To complete the transaction, Bank entered into an agreement with Taxpayer whereby Taxpayer took possession of the Property under terms substantially identical to those that would have been applicable if Taxpayer had borrowed money for the purchase of the Property.

In order to effectuate Taxpayer's goal of avoiding the payment of amounts expressly denominated as interest on borrowed funds for the purchase of the Property, while achieving the same results from an economic standpoint, Taxpayer entered into an arrangement with Bank that was structured as follows. First, Bank "purchased" the Property from the original seller under a sales contract by paying the purchase price in excess of the down payment. Second, Bank entered into an agreement (the "Lease") to lease the Property to Taxpayer for a period of 30 years (the "Lease Term"). Finally, Taxpayer and Bank entered into an agreement (the "Agreement to Purchase") pursuant to which Taxpayer is entitled to purchase the Property from Bank at any time during the Lease Term for a specified amount (the "Purchase Price").

Under the terms of the Lease, Taxpayer makes monthly "rental" payments to Bank. These "rental" payments will be established to be equal to the sum of three amounts:

- (1) Real estate taxes and insurance premiums (if applicable);
- (2) A payment to be applied against the purchase price under the Agreement to Purchase (the "Monthly on Account Payments"); and
- (3) Other specified payments ("Specific Payments") consisting of other amounts that Taxpayer has assumed or agreed to pay to Bank under the terms of the Lease.

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The real estate taxes due as part of the first component are the taxes payable based on tax rates in effect as of the date of the Lease. Taxpayer is required to reimburse Bank for any increase in real estate taxes within 10 days of notice from Bank. Conversely, if real estate taxes on the Property decrease, Bank must credit the amount of such decrease against the balance of the Purchase Price. Bank is responsible for insurance premiums with respect to risk insurance on the Property during the Lease Term (an amount that is factored into the "rental" payments) unless Taxpayer's acts or omissions cause an increase in Bank's premiums, in which case Taxpayer will be liable for such increase.

Pursuant to the Agreement to Purchase, Taxpayer may exercise his right to purchase the Property (the "Purchase Right") at any time. Taxpayer is deemed to assign the down payment it made with respect to the Property to Bank as consideration for the Purchase Right. Upon exercise of the Purchase Right, the Purchase Price to be paid by Taxpayer for the Property is equal to the original purchase price for the Property less the down payment, and is further reduced by the portion of Taxpayer's rental payments that constitute Monthly on Account Payments. If Taxpayer exercises his Purchase Right after the final rental payment is made under the terms of the Lease, the Purchase Price will be one dollar.

In the case of a fire, flood, or other casualty covered by risk insurance, Bank is entitled to receive any and all insurance proceeds. Bank will use such proceeds to restore or repair the Property if restoration or repair is economically feasible. Otherwise, Bank must provide Taxpayer with written notice of casualty (the "Casualty Notice"). Upon receipt of the Casualty Notice, Taxpayer may either (1) elect to exercise his Purchase Right, in which case the insurance proceeds would be applied against the Purchase Price, and the remainder of such proceeds (if any) would be paid by Bank to Taxpayer; or (2) elect to terminate the Lease and the Agreement to Purchase, in which case Bank will repay Taxpayer the down payment and Monthly On-Account Payments made to date. Under the terms of the Lease, Taxpayer waives warranties of habitability with respect to the Property.

Under the Lease, upon a default by Taxpayer under his "rental" obligations, Bank is provided with the same remedies against Taxpayer as would be available to a lender on a nonrecourse mortgage. If Taxpayer defaults under the lease and fails to cure such default within the specified period of time, Bank may give Taxpayer notice (a "Sale Notice") that it elects to cause the Property to be sold. If Taxpayer does not pay the balance of the Purchase Price within 30 days of receipt of the Sale Notice, Bank may commence an action to foreclose the Agreement to Purchase as a mortgage. The proceeds of such a foreclosure action would be applied in the following order:

- (1) First, to pay Bank's expenses incurred in connection with the foreclosure;
- (2) Second, to any real estate taxes, insurance premiums, or Specific Payments then owing to Bank under the Lease as of the date of sale;

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- (3) Third, to pay Bank the balance of the Purchase Price for the Property; and
- (4) Finally, the remainder to Taxpayer. Taxpayer's liability under the Agreement to Purchase is limited to the amount of the down payment plus the amount of any Monthly on Account Payments actually applied toward the Purchase Price.

The Office of the Comptroller of the Currency of the Department of Treasury has concluded that Bank's home financing arrangement is permissible and within the scope of the business of banking. [REDACTED] Specifically, the Comptroller found that Bank's home financing arrangement is functionally equivalent to or a logical outgrowth of secured real estate lending or mortgage lending, activities that are part of the business of banking. The Comptroller further noted that Bank's home financing arrangement did not violate 12 USC 29, which prohibits banks from holding legal title to real estate for a period longer than five years. The Comptroller stated [REDACTED]

#### LAW APPLICABLE TO ISSUE (1):

Section 163(a) provides that taxpayers generally may deduct all interest paid or accrued within the taxable year on indebtedness. See also § 1.163-1(a) of the Income Tax Regulations. Interest paid by the taxpayer on a mortgage upon real estate of which the taxpayer 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 indebtedness. Section 1.163-1(b).

Section 163(h)(1) provides that, in the case of taxpayers other than corporations, no deduction is allowed for personal interest paid or accrued during the taxable year. See also § 1.163-9T(a) of the temporary Income Tax Regulations. Section 163(h)(2)(D) provides that the term "personal interest" does not include any qualified residence interest within the meaning of § 163(h)(3). See also § 1.163-9T(b)(1)(iv). Thus, qualified residence interest generally is deductible under § 163(a). Section 1.163-10T(b).

Section 163(h)(3)(A) provides that "qualified residence interest" means any interest which is paid or accrued during the taxable year on (1) acquisition indebtedness with respect to any qualified residence of the taxpayer, or (2) home equity indebtedness with respect to any qualified residence of the taxpayer.

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Section 163(h)(3)(B)(i) provides that “acquisition indebtedness” means any indebtedness which (1) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and (2) is secured by such residence. Section 163(h)(B)(ii) provides that the aggregate amount treated as acquisition indebtedness for any period cannot exceed \$1,000,000 (\$500,000 in the case of a married individual filing a separate return).

Section 163(h)(4)(A)(i) defines “qualified residence,” in part, as the principal residence (within the meaning of § 121) of the taxpayer. See also § 1.163-10T(p)(1). The determination of whether any property is a qualified residence of the taxpayer is made as of the time the interest is accrued. Section 163(h)(3)(A).

In Rev. Rul. 55-540, 1955-2 C.B. 39, the Service published guidelines for distinguishing a conditional sales contract from a lease. Section 4.01 of that ruling provides that whatever interest is obtained by a lessee is acquired under the terms of the agreement itself. Whether an agreement, which in form is a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed. In ascertaining intent, no single test, or any special combination of tests, is absolutely determinative. Instead, each case must be decided in the light of its particular facts. Section 4.01 of Rev. Rul. 55-540. See also Rev. Rul. 55-542, 1955-2 C.B. 59.

Section 4.01 of Rev. Rul. 55-540 presents several judicially accepted factors for determining whether a transaction is a sale or a lease. The factors most indicative of a sale include: (1) portions of the periodic payments are made specifically applicable to an equity interest in the property to be acquired by the lessee; (2) the lessee will acquire title upon payment of a stated amount of “rentals” which, under the contract, the lessee is required to make; (3) the total amount the lessee is required to pay for a relatively short period of use (or possession) constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title; (4) the agreed “rental” payments materially exceed the current fair rental value (this may be indicative that the payments include an element other than compensation for the use of the property); (5) the property may be acquired under a purchase option at a price that is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or that is a relatively small amount when compared with the total payments that are required to be made; and (6) some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

Section 4.04 of Rev. Rul. 55-540 provides, in part, that rental payments at an hourly, daily, or weekly rate, or based on production, use, mileage, or a similar measure and not directly related to the normal purchase price, indicate an intent to rent. Section 4.05 provides that a conditional sales contract is intended if the total of the rental

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payments approximates the price at which the property could have been acquired by purchase at the time of entering into the agreement. Section 4.06 provides that a sales contract is intended if the sum of the specified "rentals" over a short part of the expected useful life of the property approximates the price at which the property could have been acquired.

LAW APPLICABLE TO ISSUE (2):

Section 164(a)(1) provides that taxpayers generally may deduct state and local, and foreign, real property taxes for the taxable year within which paid or accrued. See also § 1.164-1(a)(1). In general, taxes are deductible only by the person upon whom they are imposed. Section 1.164-1(a). Section 1.164-3(b) defines real property taxes, in part, as taxes imposed on interests in real property and levied for the general public welfare.

We hope this information is helpful. If you have any questions about the information in this letter, please contact Kim Koch of my office at (202) 622-4950.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Associate Chief Counsel  
(Income Tax & Accounting)

By: \_\_\_\_\_  
Douglas Fahey  
Acting Chief, Branch 5