

Most people are aware that they can deduct the interest that they pay on their home mortgage. However, there are limitations and many taxpayers may find themselves paying penalties and interest if they fail to follow the complex rules. One of the largest problems is refinancing. Many taxpayers have refinanced their home mortgages in the last few years for a range of reasons. They may have wanted to take advantage of lower interest rates or taken cash out of their home to use for other purposes. While there is nothing wrong in doing either of these they may have put themselves in a position that all the interest that they are paying is not deductible. Listed below are some of the rules and an example of the problem I just noted.

In most cases you can fully deduct the interest paid on a loan if the proceeds are used to buy, build a residence or make substantial improvements. The debt is limited to a maximum of two homes, an aggregate debt of \$1 million, and the loan must be secured by your home. This type of financing is called acquisition debt.

For example, if you pay \$200,000 to purchase your home in the year 2000 the interest you paid on that mortgage is fully deductible. Then in 2005 you decide to do some home improvements, such as finish the basement or add a sunroom. In order to fund these improvements you refinance your mortgage with a current loan balance of \$190,000 and increase the balance to \$220,000. All of the interest on the new loan would be deductible since you used the additional funds for qualified home acquisition debt.

What if you simply wanted to refinance your loan just to take advantage of lower interest rates? That is perfectly fine; however, you should only finance the current balance of your mortgage. If you take additional funds the interest may not be fully deductible. The loan in excess of your current balance may be considered home equity debt (We will discuss further down) or personal debt that is not deductible. You can't deduct the interest you pay on a loan to pay for personal expenses, such as buying a new car, going on vacation, or furniture. If you took out a loan for reasons other than to buy, build, or substantially improve your home, it may qualify as home equity debt though. Home equity debt is a mortgage that does not qualify as home acquisition debt and is secured by your home. There is a limit on the amount of debt that can be treated as home equity debt. The total home equity debt on your main home and second home is limited to the smaller of \$100,000 (\$50,000 if married filing separately) or the total of each home's fair market value (FMV) reduced by the amount of its home acquisition debt.

For example, you own a home that you purchased in 2000. Its FMV now is \$270,000 and the current balance on your original mortgage is \$190,000. You decide to refinance this loan and take out an additional \$100,000 for such things as paying for you kids college tuition, paying for a new car, and taking a vacation you have always wanted. The interest on this loan would not be fully deductible. The \$190,000 of home acquisition debt would still be deductible however your home equity debt is limited to \$80,000. This is the smaller of:

- \$100,000, the maximum limit, or
- \$80,000, the amount that the FMV of \$270,000 exceeds the amount of home acquisition debt of \$190,000.

On a side note, Home Equity interest is **NOT** deductible under the alternative minimum tax (The dreaded AMT. This topic is not covered in this paper.). Therefore you may think you are receiving a tax benefit by using that line of credit to pay for items but when it comes to tax time the interest deduction will do you no good.

Refinancing is what many people are going to have a hard time with. The bank usually sends one 1098. It is completely up to you to determine how much of the loan interest is deductible. If you took cash out and used those funds for something other than home acquisition debt then you need to make sure you do not deduct personal interest.

If you need help with analyzing your deductible interest or have other tax questions please contact our office.