



## Mortgage Interest Pitfalls

If you own a home, the interest you pay on your home mortgage provides one of the best tax breaks available. However, even home mortgage interest has deductibility limitations that you need to be aware of.

It used to be the case that pretty much all mortgage interest was deductible, but after the period of skyrocketing home values and falling interest rates that created an unprecedented level of refinancing and home equity loans in last few years, some homeowners may be paying mortgage interest that exceeds IRS limits, which means that a portion of their interest is not deductible.

There are three types of debt that creates deductible mortgage interest:

1. Home acquisition debt. This is money you borrowed after Oct. 13, 1987, to buy, build, or substantially improve your main and/or second home, and is secured by that home. Your total home acquisition debt (for both homes) can't exceed \$1 million (\$500,000 if married filing separately).
2. Grandfathered debt. Grandfathered debt is debt secured by your first or second home that was taken out before Oct. 13, 1987, no matter how you used the proceeds. All of the interest you pay on grandfathered debt is fully deductible.
3. Home equity debt. Home equity debt is any debt secured by your first or second home that is not considered home acquisition debt or grandfathered debt. Basically, it includes home loans taken out for any reason other than to buy, build, or substantially improve your home; it also includes mortgage debt in excess of the \$1 million home acquisition debt limit. Interest is deductible up to \$100,000 of home equity debt (\$50,000 if married filing separately).

The deductibility issue gets complicated when you refinance. It would be easy to assume that when you refinance your mortgage, all you've done is transferred your acquisition debt to a new loan. However, interest on a refinanced mortgage will be deductible only if it falls into one of the three debt categories listed above.

For example, if the old mortgage that you're refinancing is home acquisition debt, your new mortgage will also be home acquisition debt—*up to the principal balance of the old mortgage just before it was refinanced*. The interest on this portion of the new mortgage will be deductible. Any debt in excess of this limit (if not used to substantially improve your home) won't be home acquisition debt, but may qualify as home equity debt, subject to the \$100,000/\$50,000 limit. Any debt in excess of the acquisition debt plus the \$100,000/\$50,000 home equity limit will be considered personal debt and will not be deductible.

And, of course, there's the AMT (Alternative Minimum Tax) twist to consider. Interest on a home equity loan isn't deductible for purposes of the alternative minimum tax (AMT). This is an important consideration, since an increasing number of taxpayers are subject to the AMT.

With the recent drop in mortgage rates, refinancing may start to look attractive again. So if you're considering taking out (or increasing) a home equity loan or refinancing your current mortgage (again), it will be important to understand the type of debt you'll have in order to determine deductibility limits, if any. This may mean reconstructing the loan history of your home and documenting how the funds were used.

Of course, deductibility should not be the only consideration for taking on new or additional home related debt; nonetheless, understanding if the interest paid will or will not be deductible is an important factor in your decision making process and in determining the true cost of your loan.

-- Karen O'Brien. Posted 02/15/08.