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## **HOME MORTGAGE INTEREST**

While the tax deduction for home mortgage interest is as American as apple pie, the recipe can be very complicated. The home mortgage interest deduction is an example of a simple general rule with extensive and complicated exceptions.

In the good old days, people simply deducted interest that they paid. There was no distinction made between interest paid on mortgages, credit cards or other types of non-business interest. The government felt that the tax code was too complicated and set out to simplify things for taxpayers. The Tax Reform Act of 1986 was the culmination of the government's simplification effort gone horribly wrong. The TRA of 1986 included sweeping changes in the rules for deducting interest that is not incurred relating to a business.

In general, you (i.e. individuals) can deduct the interest that you pay on your home mortgage. The deduction is taken as an Itemized Deduction on Schedule A, attached to your Federal Form 1040.

However, when you dig a little further, you discover that the amount that is deductible depends upon many factors, including: the date that you borrowed the money, the amount that you borrowed, your use of the loan proceeds, how you use the home, how many homes you have, etc. Here is a list of the more common considerations in determining how much interest is deductible as home mortgage interest.

1. **Secured Debt:** The loan must be secured by a mortgage that is recorded as a lien against on your home. For example, if your father lends you money to buy your home, the interest is not deductible by you unless your father records a mortgage lien against your home with the local county recorder.
2. **Liability:** The person seeking the deduction must be legally liable on the loan. This means that paying the mortgage of a relative or friend does not allow you a deduction unless you are listed on the loan documents as being liable for payment of the debt.
3. **Payor:** The person seeking the deduction must be the person that made the payments. This goes back to a basic postulate of the tax laws that you cannot

take a deduction for something that you did not pay for. If one of your relatives or friends makes a mortgage payment on your behalf, you cannot deduct the interest. Of course, with a slightly different arrangement, you may be able to get the deduction. For example, borrow the money from your relative or friend and make the payment yourself, out of your own checking account.

4. Residence: The property must be a residence. To qualify it must be a place that you can actually live in. For example, there must be things such as a kitchen, bathroom and sleeping facilities. This can include a single family residence, condominium, cooperative, mobile home or even a boat.
5. Home Limit: Only 2 homes can qualify, your principal residence and one other home. If you have 5 homes, the homes that qualify are your principal residence, plus one other as selected by you. If you change your principal residence or buy a new home, you can have different homes qualifying during different parts of the year, on a pro-rata basis.
6. Rental: Things get more complicated where you rent out a home for part of the time. If you rent out a home to someone else then you must determine whether you can deduct the interest as home mortgage interest as an Itemized Deduction on Schedule A. The test is that you must use this home more than 14 days or more than 10% of the number of days during the year that the home is rented out, whichever is longer. If you do not use the home long enough (14 days or 10% of the days rented) to satisfy the home mortgage interest test, the property is considered to be a rental property and not a second home for this purpose. Income and deductions for rental properties are reflected on Schedule E attached to your Federal Form 1040. The good news is that some of the home mortgage interest limitations do not apply. The bad news is that the Passive Loss Rules may limit or eliminate the current benefit of the interest deduction.
7. Mixed Use: Things get more complicated where you declare part of your house as your residence and part of your house as business use property. You must prorate the interest based upon the relative percentages of your home's use. The personal portion is deducted as an Itemized Deduction on Schedule A and the business portion is deducted on Form 8829.
8. The Three Categories of Mortgages: If all of your mortgages otherwise qualify (i.e. you satisfy the tests noted above), and also fit into one or more of the following three categories at all times during the year, you can deduct all of the interest on those mortgages. The three categories are as follows:
  - A. Mortgages you took out on or before October 13, 1987 (called grand fathered debt).

- B. Mortgages you took out after October 13, 1987, to buy, build, or improve your home (called home acquisition debt), but only if throughout the year these mortgages plus any grand fathered debt totaled \$1 million or less (\$500,000 or less if married filing separately).
- C. Mortgages you took out after October 13, 1987, other than to buy, build, or improve your home (sometimes called home equity debt), but only if throughout the year these mortgages totaled \$100,000 or less (\$50,000 or less if married filing separately) and totaled no more than the fair market value of your home reduced by (A) and (B).

Here are a few examples that might help you understand how these 3 categories work. For these examples, we will assume that all of the tests are satisfied except for the 3 category test limits on amounts of the mortgages.

Example 1: In 2001, you and your spouse buy your principal residence for \$900,000 and take out a \$600,000 mortgage. The entire \$600,000 qualifies as acquisition debt (category B above).

Example 2: In 2005 you and your spouse put an addition onto your home that costs \$700,000 and you take out a second mortgage on your home in the amount of \$700,000. Since you borrowed the \$700,000 to put an addition on your home, it qualifies as acquisition debt. You now have \$1.3 million of acquisition debt (\$600,000 plus \$700,000). However, of this \$1.3 million of acquisition debt, only \$1 million qualifies (the first \$600,000 plus \$400,000 of the \$700,000 borrowed in 2005). The remaining \$300,000 borrowed in 2005 does not qualify because of the \$1 million post-1987 overall acquisition debt limit (category B above).

Example 3: In 2006 you determine that your house is worth \$2 million. You and your spouse decide to take out a home equity loan in the amount of \$150,000 and use the money to buy a golf round with Tiger Woods. You can still deduct the interest on the \$1 million of acquisition debt. Further, \$100,000 of the home equity loan qualifies (category C above). The remaining \$50,000 of the home equity loan does not qualify due to the home equity loan limit (category C above).

Example 4: Let's say that in 2006 you still take out the \$150,000 home equity loan but your house is only worth \$900,000 (not \$2 million) due to a drop in real estate values. You can still deduct the interest on the \$1 million of acquisition debt. However, no part of the \$150,000 home equity loan qualifies (category C above).

- 9. Building a Home: If you take out a loan to build a house, some or all of the debt qualifies as acquisition debt. The loan only counts if the house becomes a qualified residence once it is ready for occupancy. Further, you are only allowed to count the debt incurred during a 24 month period that occurs after the date that construction

begins. For example, if you incur \$360,000 of debt evenly over a 36 month period, only \$240,000 qualifies as acquisition debt.

10. Interest Tracing: The tax laws provide for keeping track of what the borrowed money was used for and then determining the interest deduction categories that apply. That is, whether it is home mortgage interest, business interest, investment interest, etc. This is often referred to as “interest tracing”. For example, if you borrow money to use in your business, you can arrange for a traditional business loan through a local bank or, perhaps just take a large home equity loan. You may be able to deduct the interest on the home equity loan as business interest if you very carefully follow the interest tracing guidelines. The IRS gives you the map to the minefield. If you carefully map out each step you may end up with a great result. However, one misstep (even a minor and brief) may result in stepping on a mine.
11. Just When You Thought It Was Safe To Get the Deduction: Even if you are allowed to put all of your home mortgage interest on Schedule A as an Itemized Deduction, it is possible that some or all of the tax benefits will be lost if your income is too high due to the phase out of Itemized Deductions. You may also lose some of the benefit of your mortgage interest deduction due to the Alternative Minimum Tax.  
[http://www.irs.gov/publications/p936/ar02.html#en\\_US\\_publink100037166](http://www.irs.gov/publications/p936/ar02.html#en_US_publink100037166)

### **Conclusion:**

In the years leading up to the recent real estate and credit crisis, it became increasingly popular for people to own several homes. Often, there were large mortgage balances associated with those purchases. Further, in the early to mid-2000's there were rapidly rising home values, low interest rates and easy credit. Based upon this, many people were taking out home equity loans to finance their lifestyles. These events have all conspired to make the mortgage interest deduction rules a much bigger issue than they were when enacted in 1986. Many taxpayers are putting mortgage interest deductions on their tax returns to which they are not entitled. The IRS is eyeing large mortgage interest deductions as a factor in the audit selection process.

Determining your after tax cost of debt is not easy and using a “rule of thumb” might not give a realistic picture. Depending upon the facts and how precise you want to be you might need an investment advisor, a mortgage advisor and a tax advisor to figure out how to balance your debt and investments for an optimal after tax benefit.

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