Not All Home Mortgage Interest Is Deductible; The IRS is Watching

Article Highlights:

- Acquisition Debt
- Equity Debt
- Tracing Excess Debt
- Unsecured Election

One of the current IRS audit initiatives is checking to see if taxpayers are deducting too much home equity debt interest. Generally, taxpayers are allowed to deduct the interest on up to $1 million of home acquisition debt (includes subsequent debt incurred to make improvements, but not repairs) and the interest on up to $100,000 of home equity debt. Equity debt is debt not incurred to acquire or improve the home. Taxpayers frequently exceed the equity debt limit and fail to adjust their interest deduction accordingly.

The best way to explain this interest deduction limitation is by example. Let's assume you have never refinanced the original loan that was used to purchase your home, and the current principal balance of that acquisition debt is less than $1 million. However, you also have a line of credit on the home, and the debt on that line of credit is treated as equity debt. If the balance on that line of credit is $120,000, then you have exceeded the equity debt limitation and only 83.33% ($100,000/$120,000) of the equity line interest is deductible as home mortgage interest on Schedule A. The balance is not deductible unless you can trace the use of the excess debt to either investment or business use. If traceable to investments, the interest you pay on the amount traceable would be deductible as investment interest, which is also deducted on Schedule A but is limited to an amount equal to your net investment income (investment income less investment expenses). If the excess debt was used for business, you could deduct the interest on that excess debt on the appropriate business schedule.

Alternatively, the IRS allows you to elect to treat the equity line debt as "not secured" by the home, which would allow the interest on the entire equity debt to be traced to its use and deducted on the appropriate schedule if deductible. For instance, you borrow from the equity line for a down payment on a rental. If you make the "not secured" election, the interest on the amount borrowed for the rental down payment would be deductible on the Schedule E rental income and expense schedule and not subject to the home equity debt limitations.

However, one of the rules that allows home mortgage interest to be deductible is it must be secured by the home, and if the unsecured election is used, none of the interest can be traced back to the home itself. So, for example, if the equity line was used partly for the rental down payment and partially for personal reasons, the interest associated with the personal portion of the loan would not be deductible since you elected to treat it as not secured by your home.

Using the unsecured election can have unexpected results in the current year and in the future. You should use that election only after consulting with this office.

Generally, people not familiar with the sometimes complicated rules associated with home mortgage interest believe the interest shown on the Form 1098 issued by their lenders at the end of the year is fully deductible. In many cases when taxpayers have refinanced or have equity loans, that may be far from the truth and could result in an IRS inquiry and potential multi-year adjustments. In fact, for Forms 1098 issued after 2016 (thus effective for 2016 information), the IRS will be requiring lenders to include additional information, including the amount of the outstanding mortgage principal as of the beginning of the calendar year, the mortgage origination date and the address of the property securing the mortgage, which will provide the IRS with additional tools for audits.

When in doubt about how much interest you can deduct or if you have questions about how refinancing or taking on additional home mortgage debt will impact your taxes, please call this office for assistance.