Refinanced Mortgage Interest May Not All Be Deductible

Article Highlights:

- Refinancing home mortgage interest
- Acquisition debt
- Equity debt
- Traceable debt
- Allocations
- Alternative minimum tax

Mortgage interest rates continue to be low, and home values are on the uptick. If you are considering a refinance, there are some important home mortgage interest rules you should be aware of.

Generally, the mortgage interest that you may deduct on your home includes the interest paid on the acquisition debt and on up to $100,000 of equity debt, provided the combined debt does not exceed the lesser of the value of the home or $1,100,000. Acquisition debt is the debt incurred to buy the home or substantially improve it, while equity debt is funds borrowed against the home for other uses.

A big problem arises when taxpayers fail to consider that acquisition debt steadily declines over the life of the loan. So, for example, if the original acquisition debt was $400,000 and you refinance 15 years later, the acquisition debt has probably been paid down to somewhere around $300,000. In this case, if the loan was refinanced for $475,000, the refinanced debt would be allocated $300,000 to acquisition debt, $100,000 to equity debt and $75,000 to debt for which the interest would not be deductible as home mortgage interest. In this case, the interest paid on the $300,000 acquisition debt and the $100,000 equity debt would be deductible as home mortgage interest. If the use of the $75,000 can be traced to another deductible use (e.g., purchase of taxable investments or expenses related to operating a business), then the interest on the $75,000 loan would be deductible per the limitations of the other deductible use. If the use of the $75,000 cannot be traced to an interest-deductible use, then the interest would not be deductible.

In the example above, the interest would be allocated as follows: 63.15% as acquisition debt interest, 21.05% as equity debt interest and 15.79% as interest not deductible as home mortgage interest. The result would be different if some or all of the new loan in excess of the $300,000 acquisition debt was used to make improvements to the home. For example, say that $125,000 of the new loan was used to add a bedroom and bathroom to the home. This increases the home acquisition debt to $425,000, leaving $50,000 as equity debt, and the interest would all be deductible because the equity debt amount would then be under $100,000.

If you have already refinanced or are thinking of doing so, it is imperative that you retain a record of the terms of the original acquisition debt in case you exceed the debt limitation and need to prorate your interest deduction.

When refinancing, you also need to watch out for the alternative minimum tax (AMT). The AMT is another way of computing tax liability that is used if it is greater than the regular method. Congress originally conceived the AMT as a means of extracting a minimum tax from high-income taxpayers who have significant items of tax shelter and/or tax-favored deductions. Since the AMT was created, inflation has driven up income and deductions so that more individuals are becoming subject to the AMT.

When computing the AMT, only the acquisition debt interest is allowed as a deduction; home equity debt interest is not. Neither is the interest on debt for unconventional homes such as boats and motor homes, even if they are the primary residence of the taxpayer.

Before you refinance a home mortgage, it may be appropriate to contact this office to determine the tax implication of your planned refinance and see if there are any other suitable alternatives.