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Greetings to my Friends and Clients,

The Rules for Deducting Mortgage Interest

I am often asked about the deductibility of mortgage interest. Many people just assume that all mortgage interest is deductible - but that is not the case, especially now that many "ordinary" homes in our area are selling for well over $ 1 million. Knowing and making the best of the rules is essential when you purchase a home.

The rules are spelled out in IRS Publication 936 (in mind-numbing detail of course). In this issue, I will provide you some of the highlights that might be useful to you. Of course, I am not a CPA, so I must tell you to please check with your CPA for tax advice on your specific situation.

This occasional newsletter is sent to my clients and friends. I appreciate your feedback and hope you find the information valuable. Of course, if you would rather not receive them, I will be happy to remove you from the list.

A QUICK REVIEW OF IRS PUBLICATION 936

According to the IRS, mortgage interest is deductible on up to $1,100,000 borrowed. This limit is divided between home acquisition debt and home equity debt as explained below. There are important restrictions to this as described below.

The mortgage debt must be a secured debt. A secured debt is one in which you sign an instrument (such as a mortgage, deed of trust, or land contract) that:

- Makes your ownership in a qualified home security for payment of the debt;
- Provides, in case of default, that your home could satisfy the debt, and
- Is recorded or is otherwise perfected under any state or local law that applies.

Your debt must be secured by a qualified home. This means your main home or your second home. A home includes a house, condominium, cooperative, mobile home, house trailer, boat, or similar property that has sleeping, cooking, and toilet facilities. You can have only one main home at any one time. This is the home where you ordinarily live most of the time. A second home is a home that you choose to treat as your second home. If you rent it out part time, there are rules regarding how long during the year you must use it to have it treated as a second home and not as an investment property. Consult the IRS Publication for clarification.

Home Acquisition Debt. This is a mortgage taken out to buy, build or substantially improve a qualified home. The total amount you can treat as home acquisition debt at any time on your main home and second home cannot be more than $1 million. If a buyer does not take a mortgage at time of purchase, they have 90 days to place a mortgage on that qualified home to still treat it as home acquisition debt.

Home Equity Debt. If you took out a loan for reasons other than to buy, build or substantially improve your home, to the extent it is more than the home acquisition debt limit (discussed earlier), this may qualify as home equity debt. The total home equity debt on your main home and second home is limited to $100,000.

MORTGAGE INTEREST DEDUCTIBILITY & THE 90 DAY RULE

Now let's look at some background on the “90 Day Rule”. First, a mortgage interest example: What if acquisition debt is paid down and re-borrowed?

Let’s say a buyer obtains a $1,000,000 loan at time of purchasing a primary residence. They then inherit lots of money and pay the balance down by 50%. This reduces the “acquisition” debt to $500,000, and the mortgage interest costs. Later, they need money again, and they re-borrow the $500,000. They are back to 1M in mortgage debt. Is it all deductible interest cost? It depends.

When acquisition debt is reduced, and then “re-borrowed”, the borrower is restricted to mortgage interest deductions on $100,000 of home equity debt. The additional interest cost on $400,000 of mortgage debt is not deductible, unless the funds are used for improvements to the property (i.e., major remodel), or for other purposes that a CPA can specify and advise on.

“The 90 Day Rule”: Buyers sometimes purchase their homes for cash with the aim of winning in a multiple offer situation, simplifying the purchase process, or closing quickly. Some plan to obtain financing after closing. The timing of this financing matters.

The 90 Day Rule specifies that “you buy your home within 90 days before or after the date you take out the mortgage”. This means that the IRS requires mortgage financing be placed within 90 days of closing to be considered “acquisition” debt for deductible mortgage interest. If this timing window is missed, your client may only be able to deduct interest on $100,000 of debt (home equity debt). Only a CPA or tax professional can determine if exceptions may apply to allow deductibility.

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