

YOUR QUESTIONS ANSWERED

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This column is the first in a series that will present questions that NAEA members have submitted to The Tax Institute's Tax Research Center and the answers provided by the service. The topic presented in this issue relates to the deductibility of interest on refinanced mortgage debt, allocating interest, and the interest tracing rules. Future articles will cover topics that all EAs who prepare tax returns tackle, such as cancellation of debt, transactions between shareholders and their small business-

es, rental real estate and passive activity losses, and more.

These questions are based on actual questions submitted, but any identification of the EA who submitted the question, client names, company names, etc. have been removed. Remember, if you have a question that you cannot resolve on your own, you can submit your question by clicking on "Ask a Tax Expert" in the Tax Research Center. The Tax Research Center is accessible through the Tax Research Services tab on the NAEA site.

INTEREST DEDUCTIBILITY ON REFINANCED MORTGAGE

Q: My client bought a house in 2002 for \$380,000, paid \$80,000 down, and took a mortgage out for \$300,000. In 2007, he refinanced for \$420,000 (the balance on the original mortgage at the time was \$275,000), and in 2010 he refinanced yet again, this time for \$480,000 (when the refi mortgage's balance was \$400,000). How is mortgage interest on the second refinancing treated?

A: For a taxpayer to deduct mortgage interest, the mortgage debt must be secured by the taxpayer's qualified residence. If the taxpayer refinances the mortgage, he or she may deduct interest paid on all acquisition debt ("incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer" - IRC §163(h)(3)(B)(i)(I)).

In this case, your client may deduct interest on up to \$275,000 of original acquisition debt, the outstanding balance of the original mortgage at the time of the first refinancing. Although not a factor in your client's case, note that acquisition debt cannot exceed \$1 million (\$500,000 in the case of a married taxpayer filing a separate return).

In addition, interest on home equity debt may be deducted because it is secured by the qualified residence. Basically, home equity debt is debt other than acquisition debt. Interest paid on home equity debt is deductible to the extent the debt does not exceed \$100,000 (or the fair market value of the home reduced by any acquisition debt, if less). Note also that while interest on home equity debt may be deductible as qualified mortgage interest debt, it is not deductible for AMT purposes if the debt is used for any purpose other than to construct or substantially improve the home.

Thus, to the extent the second refinancing exceeded the balance of the debt from the original mortgage (at the time of the first refinancing), it may be counted as home equity debt, subject to the \$100,000 limitation.

Finally, any debt that is not acquisition debt or home equity debt is personal debt, the interest on which is not deductible (unless it can be traced to another use that is deductible, such as interest paid on rental property).

In your client's case, for the 2010 refinancing, \$275,000 of the \$480,000 is acquisition debt (the balance of the original acquisition debt when the first refinancing occurred in 2007), \$100,000 is home equity debt, and \$105,000 is personal debt, the interest on which is not deductible as home mortgage interest on Schedule A.

RESOURCES

IRS Pub. 936, *Home Mortgage Interest Deduction*
IRC Sec. 163(h)(3)

ALLOCATING MORTGAGE INTEREST AND INTEREST TRACING

Q: My client had a \$110,000 mortgage outstanding on his personal residence, which was all original acquisition debt incurred after October 13, 1987. He refinanced his property for \$250,000, paid off the \$110,000 mortgage, and used the \$140,000 cash proceeds to purchase a commercial condominium. The fair market value of his principal residence is \$350,000. Can he deduct the full \$15,000 he paid in interest last year as qualified mortgage interest?

A: The amount he can deduct as mortgage interest depends on existing acquisition debt, home equity debt, and any refinanced debt that cannot be classified as either acquisition debt or home equity debt. Debt in excess of the limits on acquisition and home equity debt cannot be deducted as qualified mortgage interest. However, if the debt can be traced to another deductible use (such as business or investment debt), your client may be able to deduct the interest on that portion of the debt under the rules for business or investment expenses.

As general background, acquisition debt is debt used to acquire, build, or substantially improve one's principal residence (plus a second home). The maximum amount of such debt is \$1 million. Any debt in excess of \$1 million may be considered home equity debt, with a limit generally the lesser of \$100,000 or the FMV of the home reduced by acquisition debt. While there is no dollar limit on qualified mortgage interest itself, interest on acquisition debt and home equity debt over these amounts is not deductible as home mortgage interest.

In this case, because the amount of refinanced debt exceeded the outstanding acquisi-

tion debt plus home equity debt, an allocation is necessary. The allocation formula determines how the refinanced debt must be allocated to acquisition debt, home equity debt, and other debt. Once the allocation is made, the interest on such debt can be traced to its "source" and reported appropriately.

In your client's case, the amount of interest on the refinanced debt that may be deducted as mortgage interest on Schedule A may be calculated as shown in Table 1 of IRS Pub. 936, *Home Mortgage Interest Deduction* (<http://www.irs.gov/pub/irs-pdf/p936.pdf>). With no grandfathered debt or other home equity debt, and a balance of \$110,000 in acquisition debt (you will need to determine the average balance), your client can allocate approximately \$12,600 to the qualified home mortgage interest deduction on Schedule A, and approximately \$2,400 may be deductible as investment interest or as interest on a business loan.

Note: It isn't clear how the property is being used. If the property is an investment, the amount of investment interest expense that may be deducted is limited to net investment income.

On a related note, your client could have structured the refinanced amount by taking separate loans and specifically identifying

their usage. For example, if he were to have taken one loan for \$110,000 (to pay off his existing mortgage balance), a second loan for \$100,000 (as a home equity loan), and a third loan for \$40,000 (for the business loan), there would be no need to make the allocation described previously.

Finally, he could elect to treat a loan that is secured by his home as not secured by the home (for tax purposes). Doing so has its benefits, but also its costs. He could not deduct as home mortgage interest any interest on a loan if he elected to treat it as not secured by the home (in this case, that would likely prevent a deduction on interest paid on the \$110,000 refinanced acquisition debt). However, he might decide to make this election if he could fully utilize the interest expense deduction outside of mortgage interest, he was subject to AMT, a phase-out of itemized deductions (possibly again after 2012), or he had reached a limitation in mortgage debt. **EA**

RESOURCES

IRC Sec. 163(h)(3)(C)
Temp. Reg. Sec. 1.163-10T(o)(5)(i)
IRS Pub. 535, Business Expenses,
<http://www.irs.gov/pub/irs-pdf/p535.pdf>
IRS Pub. 936, Home Mortgage Interest Deduction,
<http://www.irs.gov/pub/irs-pdf/p936.pdf>