

## Deducting Your Mortgage Interest

One of the best justifications for owning a home, at least for financial reasons, is the tax savings that result from deducting mortgage interest. The deduction for mortgage interest stands as one of the few remaining tax deductions for the typical middle class taxpayer. Despite the changes to the tax code over the past several years and the repeal and limitation of many non-housing itemized deductions, mortgage interest is still deductible. On first and second mortgages and home equity lines of credit (with some limitations) for first and second homes, your mortgage interest deduction is still a good financial incentive to buy a home. Listed below are the topics covered on this page.

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### Your Mortgage Interest Deductions

Under the current tax code, mortgage interest on first and second homes is generally deductible as long as these loans total less than \$1.1 million, making home ownership one of the best ways to trim your tax bill. The examples below illustrate how the mortgage income tax deduction affects the after-tax home ownership.

- **Homeowner Profile**
  - Gross Income - \$35,500
  - House Price/Mortgage Size - \$115,000 - \$23,000 down = \$92,000
  - Loan Type - 30-year Fixed-Rate mortgage at 10%
  - Property Tax - 1.23% of home value (\$1,415)
  - Filing Status - Files jointly/four exemptions

According to the tax code, this homeowner's deductions for mortgage interest and property taxes would be evaluated at a 15 percent marginal tax rate. Non-housing itemized deductions (i.e., state and local taxes, non-mortgage interest and so on) is estimated at \$2,000 and the standard deduction is \$5,450. Under the current tax system, the homeowner saves \$1,071 because of the mortgage interest deduction. You can figure what your own costs and savings will be by substituting your own tax figures for those on the chart.

- **Example of the impact of the Mortgage Income Tax Deduction on Annual Home Ownership Costs:**
  - **Before-Tax Home Ownership Costs**
    - Mortgage Interest=\$9,177

Property Taxes=1,415

**Total of Before-Tax Home Ownership Costs=10,592**

**Itemized Deductions**

- **Home Ownership Deductions**

  - Mortgage Interest= \$9,177

  - Property Taxes=1,415

  - Non-Home Ownership Deductions= 2,000

  - Total= 12,592**

- **Standard Deductions=5,450**

**Total Itemized Deductions=\$7,142**

**Multiply Total Itemized Deductions by Marginal Tax Rate to get Home Ownership Tax Savings:**

$\$7,142 \times .15 = \$1,071$

- **After Tax Home Ownership Costs = Home Ownership Tax - Before Tax Savings:**

$\$10,592 - 1,071 = \$9,521$

## **Two Kinds of Debt**

Under the current tax system, there are two different kinds of debt. Money you borrow to buy, build or substantially improve your residence is called "acquisition indebtedness." Money you borrow against the equity in your home, or money you take out when you refinance your home for any reason except home improvement, is called "equity indebtedness." When you borrowed the money is also important. Home loans taken out before October 14, 1987, are exempted from the new rules. You may fully deduct interest paid on these loans, regardless of their size or what you used them for. Any refinanced debt you incurred before October 14, 1987, is rolled into your total acquisition indebtedness. On loans made on or after October 14, 1987, you can deduct mortgage interest paid on acquisition indebtedness up to a total of 1 million. This means you could buy a home for \$250,000, a beach home for \$200,000, and add a family room to your first house for another \$100,000, and still have \$450,000 to spend on these homes for further improvements before you reached your limit for interest deductibility. The \$1 million is not cumulative. As you pay off a loan, you would add that amount to your total purchasing or improving up to two residences. Your equity indebtedness limit is \$100,000. That means that you can borrow up to \$100,000 of the equity in your home and use it for whatever you want. This is a change from the pre-1986 tax rule that limited your equity borrowing beyond the purchase price to certain qualified expenses, such as home improvements, medical and education expenses.

## **Refinancing Your Mortgage**

When interest rates decline, many homeowners take advantage by refinancing their mortgages. In the past, refinancing your mortgage has proved to be an excellent opportunity both to lower your interest rate and monthly payment and take equity out of

your home. When refinancing your mortgage, you will probably pay 3 percent to 6 percent of the loan amount in closing costs for surveys, legal fees and paperwork fees. Many of these closing costs are deductible, but not necessarily in the year that you refinance. If you are considering refinancing your mortgage under the current tax rules, however, there are a couple of things to bear in mind. If you refinanced before October 14, 1987, for a longer term than was remaining on the pre-October 14 loan, you may only deduct the interest paid on the mortgage for the term that was remaining on the old loan. So if you refinanced a loan with 15 years remaining for a 30-year loan with lower payments, you can only deduct the mortgage interest paid on the new loan for 15 years. The one exception is if you had a balloon mortgage payment come due after October 13, 1987 and you refinanced it to a loan of not more than 30 years; you get the deductibility for the full term of the longer loan. Any refinanced debt you incurred before October 14, 1987, is rolled into your total acquisition indebtedness. In the past, many homeowners have refinanced mortgages on their appreciating properties to draw on their equity to buy a new car or take a vacation. Under the new tax system, homeowners will no longer have unlimited mortgage interest deductions when drawing on equity. Any equity debt incurred is subject to a limit of the amount of the existing debt plus \$100,000. Say, for instance, that you bought your house 10 years ago and have seen the property grow in value from \$70,000 to \$230,000. If you refinance your mortgage (on which you now owe \$50,000), you may only deduct the interest paid on the total of your acquisition indebtedness in the property (\$50,000) plus \$100,000. You will be able to deduct the interest paid on \$150,000.

## **Second Mortgages**

A second mortgage allows the homeowner to cash in on some of the equity that has built up in the home over time. Some lenders call a second mortgage a "junior lien." Getting a second mortgage is very much like taking out your first mortgage (i.e. you will be required to pay closing costs of 3 percent to 6 percent of the loan value). You may deduct the interest paid on second mortgages made on or after October 13, 1987, up to the \$100,000 limit. The amount of second mortgages made before that date is part of your acquisition indebtedness total figure. This means that if you had \$50,000 left on your first mortgage as of that date, and had taken out a \$25,000 second mortgage on the property prior to October 14, 1987, you would have an acquisition indebtedness of \$75,000.

## **Home Equity Lines of Credit**

While the 1986 tax reform called for consumer interest deductibility to be phased out by 1991, interest deductions on equity indebtedness now are limited only by the \$100,000 cap. This means that interest paid on home equity lines of credit, loans secured by your principal or second home, is still deductible. Where the traditional second mortgage gives the homeowner money in one lump sum, the home equity line of credit allows homeowners to use the equity in their home like a giant credit card. The lender allows the homeowner to borrow at will against the equity in the home, and charges interest only on the portion of the equity borrowed against. Therefore, your interest deductions for a home equity line of credit depend on whether you borrow against the equity during that year.

## **Loan Type Affects Interest Deduction**

As we've said, the mortgage interest tax deduction is one of the best financial reasons to buy a home. You may be wondering, however, what total interest charges are like on the typical home loan. Use our mortgage calculators to compare a 30-year fixed-rate loan with a 15-year and bi-weekly mortgage for the same amount. As you can see, the amount of interest you pay over the life of your loan depends on what kind of mortgage you determine is best for you.

## **The Tax Benefits of Selling Your Home**

The tax code does not tax the profits from the sale of a home, if the proceeds are used to buy another house costing at least as much as the sales price of the old one. If you or your spouse are at least 55 years old, you may be able to sell your home and exclude the first \$125,000 of gains from your taxable income without reinvesting the money.

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