

# Limitations on Home Mortgage Interest Deductions

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The IRS reminds taxpayers that interest deductions on home mortgages are limited, including limitations for home acquisition and home equity indebtedness.

There is one limit for loans used to buy, build, or substantially improve a residence -- called home acquisition debt. There is another limit for loans secured by a qualified residence but used for other purposes -- called home equity debt. Internal Revenue Code Section 163(h) (3) provides guidance for the limitations on the home mortgage interest deduction.

The law allows taxpayers to deduct interest on two categories of indebtedness secured by their residences. Acquisition indebtedness is used to acquire, construct, or substantially improve a residence, and cannot exceed \$1,000,000. Home equity indebtedness is any debt other than acquisition indebtedness and cannot exceed \$100,000.

**Home Acquisition Debt** is any loan whose purpose is to acquire, to construct, or to substantially improve a qualified home. It also must be secured by that home.

Taxpayers may deduct interest on the loan balance of up to \$1,000,000 of home acquisition debt secured by a qualified primary or secondary residence. The limit is reduced to \$500,000 for taxpayers who are married filing separately. Interest on the excess balance of home acquisition debt may be deductible as mortgage interest paid on home equity debt, subject to the general limitations for home equity indebtedness.

For example, taxpayer A borrows \$700,000 against her primary residence and \$500,000 against her secondary residence. Both loans were used solely to acquire the residences and required interest only payments. The loan balances total \$1,200,000. Since the qualified loan amounts exceed the \$1 million limit for home acquisition debt, the mortgage interest deduction is limited. If both loans have a fixed interest rate of 6% and the total interest paid for the year was \$72,000, the total deductible mortgage interest would be \$66,000. Taxpayer A would be able to deduct \$60,000, which is the interest on the first \$1 million of home acquisition debt. An additional \$6,000 of interest paid would be deductible by the taxpayer as home equity interest because the excess acquisition debt over the \$1,000,000 balance limitation qualifies as home equity indebtedness.

**Home Equity Debt** is any loan secured by a qualified residence whose purpose is other than to acquire, construct, or substantially improve a qualified home. Acquisition loans that exceed the \$1,000,000 limit may also qualify as home equity indebtedness.

The interest deduction from a home equity loan is not unlimited. Taxpayers can generally deduct interest paid on the first \$100,000 of a home equity loan. The home equity debt limit is reduced to \$50,000 for taxpayers who are married filing separately.

If the home equity loan was used to improve the taxpayer's first or second home – or to purchase a second home – the taxpayer may be eligible for a deduction on an amount up to \$1 million or the value of the home. The deduction for home equity interest may be reduced even below the \$100,000 limit if the indebtedness exceeds the fair market value of your home.

For example, taxpayer B borrows \$250,000 in a home equity line of credit, and the amount he borrows does not exceed the fair market value of his house. He used \$100,000 to add a new kitchen to the house. The remaining \$150,000 pays for college tuition. The amount used to substantially improve your home - \$100,000 - is treated as home acquisition debt as long as the taxpayer has not exceeded the \$1,000,000 balance limitation. The other \$150,000 is treated as home equity debt because it was not used to improve the home. Taxpayer B would be able to deduct interest only up to the \$100,000 limit on the home equity debt portion of the loan.

While tax software packages may include an alert to remind taxpayers and tax return preparers that home mortgage interest deductions are limited; taxpayers need to keep good records to be able to consider these limitations when calculating their home mortgage deductions.

For most taxpayers, figuring out the home mortgage interest deduction is straight-forward. Report the interest paid from Form 1098, on Schedule A.

Taxpayers who disregard the home mortgage interest deduction limitations may be liable for the increase in tax, plus interest and penalties, computed back to the due date of the return.