Interest Expense

Interest expense is your cost to borrow money. You can generally deduct interest related to your business or on loans you took out so you could earn investment income. The IRS also allows you to deduct interest on your home mortgage in most cases. You cannot deduct interest you pay on most other debt, such as interest on your personal credit card.

Home mortgage interest. Generally, home mortgage interest is any interest you pay on a loan secured by your main home or your second home. The loan may be a mortgage to buy your home, a second mortgage, a line of credit, or a home equity loan.

You may be able to deduct home mortgage interest if you itemize your deductions and you pay interest on a loan secured by your qualified home, in which you have ownership interest.

If you took out a mortgage to buy a home, your mortgage is generally secured by the home. This means that if you default on the loan, the lender can use your home to satisfy the debt. The loan must be recorded with the local jurisdiction.

A debt is not secured by your home for IRS purposes if it is only secured because of a lien on your general assets or because someone attached your property without your consent, for example a mechanic's lien or judgment lien. A debt is also not secured by your home if it once was, but is no longer secured by your home.

Qualified home. A qualified home is your main home or second home. It can be a house, condominium, cooperative, mobile home, house trailer, boat, or similar property that has sleeping, cooking, and toilet facilities. Your main home is where you live most of the time.

If you pay interest on a mortgage on a home other than your main or second home, you can only deduct it if you used the proceeds of the loan for business, investment, or other deductible purposes. Otherwise, it is personal interest and you cannot deduct it.

The second home may be a summer or winter home, or other home you choose to treat as a second home. If you do not hold out your second home for rent or resale to others at any time during the year, you can treat it as a qualified home, even if you do not actually use the home during the year.

However, if you have a second home that you rent out part of the year, you must also use it as a home during the year for it to be a qualified home. You must use it more than 14 days or 10% of the number of days during the year that you rent the home at a fair rental, whichever is longer. If you do not use the home at least the minimum amount, you must treat it as rental property and not as a second home.

More than one second home. If you have more than one second home, you can treat only one as the qualified second home during any year. However, you can change the home your treat as a second home during the year in the following situations:

- If you get a new home during the year, you can choose to treat the new home as your second home as of the day you buy it.
- When your main home no longer qualifies as your main home, you can choose to treat it as your second home as of the day you stop using it as your main home.
- If you sell your second home during the year or start using it as your main home, you can choose a new second home as of the day that you sell the old one or begin using it as your main home.

Divided use of your home. If you use part of your home for living and part of it for business, only the part you live in is a qualified home. You must allocate the use of your home between business and personal use.

Renting out part of home. If you rent out part of a qualified home to another person (tenant), you can treat the rented part as if you use it for residential living if *all* of the following conditions are true:

- The tenant uses the rented part of your home is primarily for residential living.
- The rented part of your home is not a self-contained residential unit having separate sleeping, cooking, and toilet facilities.
- You do not rent your home to more than two tenants at any time during the tax year. Two persons and their dependents who share the same sleeping quarters are one tenant for this purpose.

Home under construction. You can treat your home under construction as a qualified home for up to 24 months if it becomes your qualified home when it is finished.

Home destroyed. You may be able to continue treating your home as a qualified home even after it is destroyed in a fire, storm, tornado, earthquake, or other casualty and continue to deduct mortgage interest if you rebuild the home and move into it, or you sell the land, within a reasonable time.

Time-sharing arrangements. You can treat a home you own under a time-sharing plan as a qualified home if it meets all the requirements. A time-sharing plan is an arrangement between two or more people that limits each person's interest in the home or right to use it to a certain part of the year.

If you rent out your time-share, it qualifies as a second home only if you also use it as a home during the year. To determine whether you meet the use requirement, count your days of use and rental of the home only during the time you have a right to use it or to receive any benefits from the rental of it.

Married taxpayers. If you are married and file a joint return, your qualified home may be owned either jointly or by one spouse.

If you are married filing separately and you and your spouse own more than one home, you can each take into account only one home as a qualified home. However, if you both consent in writing, then one spouse can take both the main home and a second home into account.

Divorced or separated individuals. If a divorce or separation agreement requires you or your spouse or former spouse to pay home mortgage interest on a home owned by both of you, the payment of interest may be alimony.

More than one borrower. If you and at least one other person (other than your spouse if you file a joint return) were liable for and paid interest on a mortgage that was for your home, and the other person received a Form 1098 showing the interest that was paid during the year, attach a statement to your return explaining this. Show how much interest each of you paid, and give the name and address of the person who received the form. Deduct only your share of the interest.

If you are the person that received Form 1098 on which there are other borrowers entitled to a deduction for the interest shown, deduct only your share of the interest. Be sure to tell the other borrowers the amounts of their shares of interest.

Late payment charge on mortgage payment. You can deduct as home mortgage interest a late payment service charge if it was not for a specific service performed in connection with your mortgage loan.

Mortgage prepayment penalty. If you pay off your home mortgage early, you may have to pay a penalty. You can deduct the penalty as home mortgage interest, as long as the penalty is not for a specific service performed or other cost connected to your mortgage loan.

Sale of home. If you sell your home, you can deduct the home mortgage interest you pay up to, but not including, the date of the sale.

> **Example:** Jeff and Sara sold their home on April 10. As of March 31, they had paid $1,500 in home mortgage interest for the year. The settlement sheet for the home sale shows $150 interest for the nine-day period in April, not including the date of sale. Their mortgage interest deduction for the year is $1,650 ($1,500 + 150 = $1,650).

Prepaid interest. If you pay interest in advance for a period that goes beyond the end of the tax year, you must allocate this interest to the tax years for which it applies. Each year, you can deduct only the interest that qualifies as home mortgage interest for that year. (See the exception for points.)

Mortgage interest credit. You may be able to claim a mortgage interest credit if you were issued a mortgage credit certificate (MCC) by a state or local government.

Enter your information in the *Other credits* section under the **Credits** tab. TaxACT calculates your credit on *Form 8396, Mortgage Interest Credit.* If you qualify for this credit, TaxACT reduces your mortgage interest deduction by the amount of the credit.

Ministers' and military housing allowance. If you are a minister or member of the uniformed services and you receive a housing allowance that is not taxable, you can still deduct your home mortgage interest.

Hardest Hit Fund and Emergency Homeowners' Loan Programs. You can use a special method to compute your deduction for mortgage interest and real estate taxes on your main home if you meet the following two conditions.

- You receive assistance under:
  - A State Housing Finance Agency (State HFA) Hardest Hit Fund program in which program payments could be used to pay mortgage interest, or
  - An Emergency Homeowners' Loan Program administered by the Department of Housing and Urban Development (HUD) or a state.
- You meet the rules to deduct all of the mortgage interest on your loan and all of the real estate taxes on your main home.

If you meet these tests, you can deduct all payments you made to your mortgage service, the State HFA, or HUD on the home mortgage, including the amount shown on Box 3 of *Form 1098-MA, Mortgage Assistance Payments.* However, you cannot deduct more than the sum of the amounts shown on Form 1098 for mortgage interest received, mortgage insurance premiums, and real property taxes.

You are not required to use this special method to compute your deduction for mortgage interest and real estate taxes on your main home.

Mortgage assistance payments under Section 235 of the National Housing Act. If you qualify for mortgage assistance payments for lower-income families under Section 235 of the National Housing Act, part or all of the interest on your mortgage may be paid for you. You cannot deduct the interest that an agency pays for you.

Do not include these mortgage assistance payments in your income. Also, do not use these payments to reduce other deductions, such as real estate taxes.

Reverse mortgages. A reverse mortgage is a loan where the lender pays you in a lump sum, a monthly advance, a line of credit, or a combination of all three while you continue to live in your home. With a reverse mortgage, you retain title to your home. Depending on the plan, your reverse mortgage becomes due with interest when you move, sell your home, reach the end of a pre-selected loan period, or die.

Reverse mortgages are loan advances, not income. Therefore, the amount you receive is not taxable. You cannot deduct any interest (including original issue discount) accrued on a reverse mortgage until you actually pay it, which is usually when you pay off the loan in full. Your deduction may be limited, because a reverse mortgage loan is generally subject to the limit on home equity debt.

Refund of interest. If you receive a refund of interest in the same tax year you paid it, reduce your interest expense by the amount refunded to you. If you receive a refund of interest you deducted in an earlier year, you generally must include the refund in income in the year you receive it, up to the amount of the deduction that reduced your tax in the earlier year. See TaxTutor Guidance for Other Income for more information.

Limits on home mortgage interest deduction
You may not be able to deduct the full amount of your mortgage interest under certain circumstances. For example, your mortgage loan may be above the

IRS limits, or you may have used the proceeds for purposes other than buying or improving a home. Your deduction for mortgage interest may also depend on when you took out your loan.

The IRS classifies home mortgage interest is either home acquisition debt or home equity debt. The rules for deducting mortgage interest and points are different depending on how your debt is classified.

Home acquisition debt is any mortgage you took out after October 13, 1987, to buy, build, or substantially improve your main or second home. The debt must be secured by your home.

You can treat up to $1 million ($500,000 if married filing separately) of total debt on your first and second homes as home acquisition debt at any time. If you have grandfathered debt (debt taken out on or before October 13, 1987), you must reduce the limit by your grandfathered debt. You may be able to treat any debt over this limit may qualify as home equity debt.

> **Important:** If your mortgage is greater than your home cost plus improvements, you can only treat up to the total of cost plus improvements as home acquisition debt. However, you may be able to treat the additional debt as home equity debt.

Refinanced home mortgage. If you refinance an existing home loan, you can treat the new secured debt as home acquisition debt just as you treated the old loan. However, if you take cash out with the refinancing, and you do not use the cash to buy, build, or improve your main or second home, you must treat the amount of debt over the old loan balance as home equity debt.

Can I deduct mortgage interest if I took out my mortgage some time before or after I bought or built my house?

Home acquisition debt is generally debt you take out when you buy a house. However, you may treat a mortgage as home acquisition debt if you qualify for one of these exceptions:

- You buy your home within 90 days before or after the mortgage date and the home acquisition debt is no more than the cost of your home plus improvements, up to the limit on home acquisition debt.
- You build or improve your home and take out the mortgage before the work is completed. The home acquisition debt must be no more than your expenses within 24 months before the mortgage date.
- You build or improve your home and take out the mortgage within 90 days after the work is completed. The home acquisition debt is limited to the amount of the expenses incurred within the period beginning 24 months before the work is completed and ending on the date of the mortgage.

Your mortgage date is the day the lender disburses the loan proceeds - generally the closing date. However, you can use the day you apply in writing for your mortgage, instead, if you receive the loan proceeds within a reasonable time (such as within 30 days) after your application is approved. If a lender rejects your timely application, the IRS allows you a reasonable time to make a new application.

> **Example:** Jack paid $125,000 cash for his main home on March 1. On May 15, he took out a mortgage of $125,000, using the home as security. He invested the $125,000 in bonds. Jack treats the mortgage as home acquisition debt because he bought the home within 90 days of taking out the mortgage. The mortgage is not more than the home’s cost, so the entire amount qualifies as home acquisition debt.

What improvements can I use to determine the total cost plus improvements of my home?

You can only count improvements to your home for determining your limit on home acquisition debt if the improvements are "substantial," by IRS standards. An improvement is substantial if it meets one of the following conditions:

- It adds to the value of your home,
- It prolongs your home’s useful life, or
- It adapts your home to new uses.

Include your costs to acquire real property and building materials, fees for architects and design plans, and required building permits.

In most cases, you not include repairs and maintenance, such as repainting your home. However, if you paint your home as part of a substantial renovation, include the painting as part of the improvements.

What if my mortgage doesn't qualify at first, but it meets the requirements later?

A mortgage that does not qualify as home acquisition debt because it does not meet all the requirements may qualify at a later time. For example, a debt that you used to buy your home may not qualify as home acquisition debt because it is not secured by the home. However, if the debt is later secured by the home, it may qualify as home acquisition debt after that time. Similarly, a debt that you use to buy property may not qualify because the property is not a qualified home. However, if the property later becomes a qualified home, the debt may qualify at that time.

Home equity debt

If you take out a loan that does not qualify as home acquisition debt, you may still be able to deduct it as home equity debt. Home equity debt is a mortgage that you took out after October 13, 1987, that does not qualify as home acquisition debt or grandfathered debt, and that is secured by your main or second home.

Example: Robert paid off his home loan five years ago. Robert took out a $30,000 loan this year using his home as security to pay for a new car. This loan is home equity debt.

You cannot deduct interest on total home equity debt on your main home and second home that exceeds the *lesser* of:

- $100,000 ($50,000 if married filing separately), or
- The total of each home's fair market value reduced (but not below zero) by the amount of its home acquisition debt and grandfathered debt, calculated as of the date the last debt was secured by each home.

Example: Caesar took out a loan to purchase a home in 1995. The current fair market value of his home is $125,000, and Caesar still owes $100,000 on the original mortgage. The bank offers him a home mortgage loan of 110% of the fair market value of his home, reduced by his existing mortgage. Caesar takes out a new $37,500 home mortgage loan with the bank.

Caesar's home equity debt is limited to $25,000. This is the lesser of:

- $100,000 (the maximum limit), or
- $25,000, the amount that the fair market value of $125,000 exceeds his home acquisition debt of $100,000 ($125,000 - 100,000 = $25,000).

If you pay interest on debt over the limit, you generally cannot take a deduction for it. However, if you used the loan proceeds for investment, business, or other deductible purposes, you may be able to deduct the interest elsewhere on your return.

Grandfathered debt. If you took out a mortgage on your home before October 14, 1987, or you refinanced such a mortgage, it may qualify as grandfathered debt. To qualify, the mortgage must have been secured by your qualified home on October 13, 1987, and at all times after that date. It does not matter how you used the proceeds for grandfathered debt.

Grandfathered debt is not subject to the limits on home acquisition or home equity debt. However, your grandfathered debt reduces the amount of your qualified non-grandfathered home acquisition and home equity debt.

Points

"Points" are certain charges you may pay when you take out a home mortgage. Sometimes points are called loan origination fees, maximum loan charges, loan discounts, or discount points. They are all treated the same for tax purposes.

If the seller pays your points for you, you should treat the points as if you paid them yourself. Reduce your cost basis in the house by the amount of the points.

Points are actually prepaid interest. You generally can deduct the full amount of points in the year you pay them if the points are for your original mortgage on the home. Otherwise, you can deduct them over the term of the mortgage.

Deduction for points allowed in the year you pay them. You can choose to fully deduct points in the year you pay them if you meet all the following conditions:

- Your loan is secured by your main home.
- Paying points is an established business practice in your area.
- The points paid are not more than the going rate in your area.
- You use the cash method of accounting (most individual taxpayers do).
- You do not pay the points in place of ordinary settlement items, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
- The points were no more than the funds you provided at or before closing, plus points the seller paid, regardless of whether your funds were applied to points. Your funds include your down payment, escrow deposit, earnest money, and other funds you paid at or before closing. You must not have borrowed these funds from your lender or mortgage broker.
- You use your loan to buy or build your main home (not your second home).
- The lender computes the points as a percentage of the principal amount of the mortgage.
- The settlement statement (such as Settlement Statement, Form HUD-1) clearly shows the amount as points, either from your funds or the seller's.

Tip: You can choose to either fully deduct the points in the year paid, or deduct them over the life of the loan. You may prefer to deduct them over the life of the loan if you expect the deduction to give you a greater tax benefit in future years.

Home improvement loan. You can also fully deduct in the year paid points you pay on a home improvement loan, if you meet the first six tests above.

Deduction for points allowed over the term of the mortgage. You cannot deduct points all in the year you pay them if the loan is for a second home, or when you refinance (unless you qualify to deduct the points on a home improvement loan).

If you cannot or choose not to deduct points in the year you pay them, you can deduct the points over the life of the loan if you meet *all* the following tests:

- You use the cash method of accounting. In other words, you report income when you receive it and deduct expenses when you pay them. Most individuals use this method.
- Your loan is secured by your main or second home.
- Your loan period is not more than 30 years.
- If your loan period is more than 10 years, the terms of your loan are the same as other loans offered in your area for the same or longer period.
- Either your loan amount is $250,000 or less, or the number of points is not more than:
  - 4, if your loan period is 15 years or less, or
  - 6, if your loan period is more than 15 years.

If you deduct points over the life of the loan, you must calculate the deductible amount each year. Your lender does not report points on your Form 1098 except in the year you purchase a main home.

Calculate your deduction for points as follows:

1. Determine the number of months of the loan (number of years X 12).
2. Divide your deductible points by the number of months.
3. Multiply the result by the number of monthly payments you made this year.

Enter your deduction for points in *Itemized Deductions - Points Not Reported*, in the *Itemized deduction - Interest* you paid section under the **Deductions** tab.

Example: In 2012, you take out a 25-year loan for $150,000. The terms of the loan are the same as other 25-year loans offered in your area. You pay $3,000 in points. You make five monthly payments on the loan in 2012. You can deduct $50, calculated as follows:

1. Determine the number of months of the loan (25 years X 12 = 300 months)
2. Divide deductible points by number of months ($3,000 / 300 months = $10).
3. Multiply result by 5 monthly payments in 2012 ($10 X 5 = $50)

Next year and every year thereafter until you use up the points, you deduct $120 ($10 x 12 months = $120).

Example: Points on loan to refinance a home
In 2012, Randy refinances his mortgage with a 20-year $100,000 mortgage loan, using his home as security. Randy pays two points ($2,000). One point, ($1,000) is for prepaid interest, and one point ($1,000) is for services in place of amounts ordinarily stated separately on the settlement statement. Randy pays the points with his own funds, not with loan proceeds. The payment of points is an established practice in the area, and the points charged are not more than the amount generally charged there. Randy makes eight payments in 2012.

Randy uses the new loan to pay off his existing mortgage loan, not to purchase or improve his home. He cannot deduct all the points in 2012. He deducts one point ($1,000) ratably over the life of the loan. He deducts $33 [($1,000 / 240 months) x 8 payments] of the points in 2012.

Randy cannot deduct the other point ($1,000) because it was a fee for services.

Example: Points on loan used partially to remodel a home
Using the same facts as above, except Randy uses $10,000 of the loan

proceeds to improve his home and $90,000 to repay his existing mortgage. Randy deducts $100 ($10,000 improvements / $100,000 mortgage x $1,000 points) of the points in 2012.

Randy also deducts the remaining portion of the points that must be allocated over the life of the loan. This amount is $30 [($900 / 240 months) x 8 payments] in 2012. His total deduction for points in 2012 is $130 ($100 + 30 = $130).

Amounts charged for services. Amounts the lender charges for specific services connected to the loan are not interest and are not deductible as points, including:

- Appraisal fees
- Notary fees
- Preparation costs for the mortgage note or deed of trust

Points remaining at the end of a mortgage. If you allocate your points deduction over the life of the mortgage, you can deduct any remaining balance in the year the mortgage ends, for example, when you sell the home, pay off the mortgage, or give up the home in foreclosure.

However, if you refinance with the same lender, you cannot deduct any remaining balance of points in the year you refinance. Instead, deduct the remaining balance over the term of the new loan.

Example: Harrison paid $4,000 in points in 1996 that he had to spread out over the 20-year life of the mortgage. He deducts $200 in points per year. As of 2011, Dan has deducted $3,000 in points. Dan prepays his mortgage in full in 2012. He deducts the remaining $1,000 in points in 2012.

Points deduction when mortgage is limited. You cannot fully deduct points paid on a mortgage that exceeds the limits for interest deduction (generally $1 million for home acquisition debt or $100,000 for home equity debt).

Mortgage insurance premiums. You may be able to treat amounts you paid during 2012 for qualified mortgage insurance as home mortgage interest. The insurance must be in connection with home acquisition debt, and the insurance contract must have been issued after 2006 by the Department of Veterans Affairs, the Federal Housing Administration, the Rural Housing Service, or private mortgage insurance.

Mortgage insurance provided by the Department of Veterans Affairs is commonly known as a funding fee. If provided by the Rural Housing Service, it is commonly known as a guarantee fee. The funding fee and guarantee fee can either be included in the amount of the loan or paid in full at the time of closing.

You can fully deduct these fees (subject to the adjusted gross income limitation) in 2012 if the mortgage insurance contract was issued in 2012. If it is not reported in Box 4 of your Form 1098, contact the mortgage insurance issuer to determine the deductible amount.

Prepaid mortgage insurance. Generally, if you paid premiums for qualified mortgage insurance that are properly allocable to periods after the close of the tax year, you treat such premiums as if you paid them in the period to which they are allocated. You must allocate the premiums over the shorter of the stated term of the mortgage or 84 months, beginning the month you obtained the insurance.

You cannot take a deduction for prepaid mortgage insurance that you have not already deducted if the mortgage is satisfied before its term. (This information does not apply to qualified mortgage insurance provided by the Department of Veteran Affairs or the Rural Housing Service.)

If your adjusted gross income on Form 1040, line 38, is more than $100,000 ($50,000 if your filing status is married filing separately), the amount of your mortgage insurance premiums that are otherwise deductible is reduced. If your adjusted gross income is more than $109,000 ($54,500 if married filing separately), you cannot deduct your mortgage insurance premiums.

Example: Todd purchased a home in June of 2011 and took out a 15-year mortgage. At closing, Todd prepaid all $8,400 of required private mortgage insurance. Todd must allocate the $8,400 over the shorter of the life of the mortgage or 84 months, which in his case is 84 months. Todd's adjusted gross income (AGI) for 2011 is $64,000, which is less than the limit for the qualified mortgage insurance deduction. Todd deducts $700 for qualified mortgage insurance premiums in 2011 (($8,400 / 84 months) X 7 months = $700).

For 2012, Todd deducts $1,200 ($8,400 / 84 months X 12 months).

Form 1098, Mortgage interest statement

If you pay $600 or more of mortgage interest (including certain points and mortgage insurance premiums) during the year on any one mortgage, you generally receive Form 1098 or a similar statement from the mortgage holder. You should receive the statement if you pay interest to a bank, government unit, or other lending institution.

You lender sends the statement to you and to the IRS by January 31 of the following year. The statement shows the following items in Boxes 1 - 4:

Box 1. Mortgage interest you pay during the year.

Box 2. If you purchase a main home during the year, the deductible points you pay during the year, including seller-paid points, but not including any interest a government agency paid on your behalf.

Box 3. Any refund of mortgage interest you overpaid in an earlier year.

Box 4. The lender may show other items in this box, such as mortgage insurance premiums. (The mortgage insurance premium deduction is not available for 2012 unless Congress acts to extend it.)

Form 1098 generally only includes points you can fully deduct in the year you pay them. You may be able to deduct points that your lender does not report on Form 1098.

If you prepay interest in 2012 that accrued in full by January 15, 2013, your lender may include this prepaid interest in Box 1 of Form 1098. However, you cannot deduct any prepaid amount for January 2013 in 2012. You must subtract any interest that was for 2013 from the amount in Box 1 and include it with other interest you pay for 2013.