Getting Your Home Mortgage Interest Deductions

M. Jill Lockwood
For many taxpayers, the interest deduction on a personal residence is the largest single deduction on their income tax return, often exceeding the standard deduction limits. This means most taxpayers who pay mortgage interest itemize their deductions.

If you itemize, you must keep accurate records and be able to prove your deduction was correct and proper if you are audited. What do you need to know? First, you need to know what your home mortgage interest is. Interest is the cost you pay to borrow money. This may include interest, mortgage insurance and discount points.

To qualify for the mortgage interest deduction, your home must be the collateral for the money you borrow from a bank or other financial institution. This means the lender has a mortgage or other security interest filed against your house that can be enforced if you default on your loan. Many individuals borrow money against their investments to purchase a home. If this is the case, the security on the loan is the investments and not your home and any interest paid for this loan does not qualify as a deduction.

For your home to be the collateral for the loan, the value of the home must be equal to or greater than the amount of the loan. This presents a problem for taxpayers who bought homes at the top of the housing boom and put no money down.

What if you have two homes? The law will allow you to deduct interest for both so long as the homes are collateral for the debt and the amount you borrowed to buy, build or improve your first and/or second home does not exceed $1 million. There also is a $100,000 loan limit to pay for something else. You may borrow money against the equity in your home to take a trip, or pay for college tuition, medical bills or a new car — the choices are endless. The value of the home must be greater than or equal to the amount of the debt.

For example: Susan and Joe bought a house in Savannah in 1990 for $250,000; they put $50,000 down and borrowed the rest. The house is now worth $450,000 and they borrowed $250,000 to buy a second home in Maine. The home in Maine is a second home, but it isn’t the collateral for the $250,000 loan. The home in Savannah is the collateral and the $250,000 is not being used to substantially improve that home; it is being used for something else.

If Susan and Joe want to deduct all the interest they pay for the home in Maine, they need to see their banker about permanent financing. Otherwise, they will only be able to deduct 40 percent of the interest on the second loan ($100,000/ $250,000 x interest expense).

Warning: Losing part of the interest deduction may not be Susan and Joe’s biggest problem. If Susan and Joe have one large debt on their principal residence and cannot pay the interest, they risk losing everything.

If Susan and Joe get separated and sell the second house and discover they can pay the mortgage on the principal residence, but the second house becomes too much, they may lose the second house if they cannot sell it. But they do not set themselves up to lose the primary house as well.

Second example: Susan and Joe bought a house in Savannah in 2006 for $750,000 and sold it out of necessity because the house was no longer worth $500,000. Susan and Joe can only deduct two-thirds of the interest they pay on the house ($500,000/ $750,000 x interest expense).

The lender does not do the math on any of this. The lender just sends you a 1098 or other statement giving you the amount of interest you paid on your loan. It is up to you to determine if the interest qualifies as home mortgage interest deduction. If you have any questions, please see your CPA.

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