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REFINANCING A HOME MORTGAGE - TAX CONSIDERATIONS

Introduction

With the likelihood of home mortgage rates rising, homeowners with adjustable-rate mortgages or higher-interest fixed rate mortgages obtained many years ago may be motivated to refinance now. Others may find that refinancing a loan to renovate or expand a home may be more cost effective than trading up to another home.

The following summarizes the tax considerations taxpayers should be aware of when they consider refinancing their home loans.

Deductions from exiting the old mortgage. Prepayment penalties are deductible as interest subject to the rules of Section 163 of the Internal Revenue Code of 1986, as amended ("Code"). Accordingly, if there's a penalty for paying off a mortgage early, it's fully deductible if the retired debt itself qualified as acquisition debt or home-equity debt under Code Section 163(h)(3).

In addition, if the borrower had to deduct points over the life of the old mortgage, the remaining unamortized portion of the points charged generally may be deducted currently as interest (again, assuming the underlying loan qualified).

However, if the mortgage loan is refinanced with the same lender, the Internal Revenue Service ("IRS") says the remaining balance of capitalized points must be deducted over the term of the new loan, not in the year the prior mortgage ends.

Points on the new loan. If the conditions of Code Section 461(g)(2), Regulation Section 1.6050H-1(f)(1) and Regulation Section 1.6050H-1(f)(2) are satisfied, points paid in connection with the purchase or improvement of a principal residence are currently deductible. IRS says that points on a refinance loan are deductible:

1. Only if the borrower pays the charge out of his own cash at the closing (i.e., the charge isn't withheld from the mortgage loan); and
2. Only to the extent the proceeds are used to improve the residence.

The currently deductible amount is based on the ratio of borrowed funds used for improvements to the total amount of the loan. The balance of the points is deductible over the term of the new loan.

The Eighth Court of Appeals held that a taxpayer who financed the purchase of a residence with a 3-year mortgage loan, and then refinanced in the third year, could currently deduct the points on the refinance loan. However, the IRS won't follow this case outside of the Eighth Circuit. Furthermore, the Tax Court has held that the Eighth Circuit's rule does not apply where the original loan was a 30-year loan and the purpose of the refinancing was to obtain a lower interest rate and a fixed rather than variable interest rate.

How to handle points that can't be claimed currently. If the points aren't currently deductible under Code Section 461(g)(2), they generally must be deducted over the life of the loan using economic accrual principles. However, the IRS will, as a matter of administrative convenience, allow a borrower to find the amount the deductible annually by:

- Dividing the non-currently-deductible points by the number of monthly payments to be made on the loan, then
- Multiplying the result by the number of mortgage payments made during the tax year.

This method is available only if the points are paid in connection with a loan of not more than $250,000 that:

- Is payable over no more than 30 years;
- Is secured by the residence; and
- Carries no more than 6 points if the term exceeds 15 years, or no more than 4 points for shorter loans.

(**Note:** The economic accrual method "front loads" the deductible amount – higher deductions in the early years, smaller ones in the later years – whereas the easier-to-calculate ratable method produces a level deduction figure through the loan term.)

Deducting interest on the new loan. Interest paid on the refinance loan generally will be deductible under the following rules, assuming it is properly secured and all of the other Code Section 163(h)(3) conditions are met:

- The new loans are treated as qualified acquisition debt to the extent the new loan amount doesn't exceed the balance remaining on the original mortgage. Interest paid on qualified acquisition debt of up to $1 million is fully deductible.
- Borrowed funds in excess of the amount necessary to retire the old mortgage also are treated as acquisition debt to the extent used for "substantially improving" the residence. IRS says that any improvement that adds to the home's value, prolongs its useful life, or adapts the home to new uses qualifies as "substantial". Repairs that maintain a home in good condition, such as repainting the home, are not substantial improvements. But if the taxpayer paints the home as part of a renovation that substantially improves the qualified home, he can include the painting costs in the cost of the improvements.
- To the extent they aren't used for substantial improvements, borrowed funds in excess of the amount necessary to retire the old mortgage may be treated as home-equity debt. Generally, the interest paid on up to $100,000 may be treated as home-equity debt is deductible regardless of how the proceeds are used.

(**Note:** Even if all of the home-equity debt provisions are met, the interest won't be deductible to the extent the deduction is disallowed by another provision such as the Code Section 265(a)(2) prohibition against deducting interest on debt to buy or carry tax-exempt bonds.)

Part principal residence, part business property. A person's home may be used partly for business purposes (e.g., a home office or rented to others). In these situations, allocations are required, and part of the loan automatically will be disqualified from the favorable qualified residence interest rules. That's because residence interest is deductible only to the extent the loan is secured by the taxpayer's principal residence (his or her main home) or another property treated as a residence under the Code Section 280A(d)(1) vacation home rule. Therefore, to the extent the loan is secured by a home office or rented rooms, it can't be qualified debt. No allocation is required, however, if the tenants are residential, there aren't more than 2 different tenants and the rented portion isn't a self-contained living unit with separate sleeping space and toilet and cooking facilities.