

If you own a home, the interest you pay on your home mortgage provides one of the best tax breaks available. However, many taxpayers believe that *any* interest paid on their home mortgage loan is deductible. Sadly, they're wrong. With home prices skyrocketing in many states, now's a good time to revisit the interest deduction rules for home mortgages and home equity loans.

It used to be the case that pretty much all interest payments were deductible. Since 1986, however, deductibility has become very complicated. Personal interest is disallowed, but one kind of interest that remains deductible is qualified residence interest. Qualified residence interest is interest incurred from buying, building, or improving your qualified residence, or from home equity loans on that residence. You can deduct interest from up to two qualified residences: your primary home and one other vacation home or similar property. You cannot deduct mortgage interest with respect to a third residence.

However, this deal comes with strings attached. You can't deduct the interest for acquisition debt greater than \$1 million (\$500,000 for married individuals filing separately). So, for example, if you were to buy a \$2 million house with a \$1.5 million mortgage, only the interest that you pay on the first \$1 million in debt will be deductible. The rest will be considered personal interest.

Note also that the \$1 million ceiling on deductible home mortgage debt includes both your primary residence and your second home combined. Too many taxpayers assume that they can deduct \$1 million from each mortgage. But if you have a \$700,000 mortgage on your primary home and a \$500,000 mortgage on your beach house or ski lodge, you'll have to count \$200,000 of the total as nondeductible personal interest.

The rules are different for home equity loans. Home equity debt is debt (other than acquisition debt) secured by your principal or second residence. Home equity debt is limited to the lesser of \$100,000 (\$50,000 if your filing status is married filing separately) or your equity in the home. The interest that you pay on a qualifying home equity loan is generally deductible regardless of how you use the loan proceeds, except when the proceeds are used to purchase tax-exempt obligations.

This provides some real savings opportunities if you have equity in your home and also have other debts. Credit card debt is not deductible and usually carries a higher interest rate than home equity interest. By converting your nondeductible, higher-rate, credit card debt to home equity indebtedness (i.e., use the home equity loan to pay off your credit card balance), you will save both on taxes and on the interest rate.

However, you should bear in mind that interest on a home equity loan isn't deductible for purposes of the alternative minimum tax (AMT), unless you use the loan to improve your home. This is an important consideration, since an increasing number of taxpayers are subject to the AMT.