

Interest deduction. Interest that you pay on a home mortgage is deductible within limits, depending on whether it is home acquisition debt, home equity debt, or grandfathered debt. Interest on the refinanced mortgage will be deductible if it falls into one of these categories, as explained below.

Home acquisition debt is a mortgage you took out after Oct. 13, 1987, to buy, build, or substantially improve your main or second home, and that is secured by that home. Interest on home acquisition debt is deductible, but your total home acquisition debt can't exceed \$1 million (\$500,000 if married filing separately).

Home equity debt is any debt secured by your first or second home, other than home acquisition debt, or grandfathered debt. Thus, it includes mortgage loans taken out for reasons other than to buy, build, or substantially improve your home, and mortgage debt in excess of the home acquisition debt limit. Interest is deductible on up to \$100,000 of home equity debt (\$50,000 if married filing separately).

Grandfathered debt is mortgage debt secured by your first or second home that was taken out before Oct. 14, 1987, no matter how you used the proceeds. All of the interest you pay on grandfathered debt is fully deductible.

Refinancing. If the old mortgage that you are refinancing is home acquisition debt, your new mortgage will also be home acquisition debt, up to the principal balance of the old mortgage just before it was refinanced. The interest on this portion of the new mortgage will be deductible. Any debt in excess of this limit won't be home acquisition debt, but it may qualify as home equity debt, subject to the \$100,000/\$50,000 limit.

If you are refinancing grandfathered (pre-Oct. 14, 1987) debt for an amount that isn't more than the remaining debt principal, the refinanced debt will still be grandfathered debt. If the new debt exceeds the mortgage principal on the old debt, the excess will be treated as home acquisition or home equity debt.

Grandfathered debt that was refinanced is treated as grandfathered debt only for the period that remained on the old debt that was refinanced. Once that period ends, you must treat the debt as home acquisition debt or home equity debt, based on how the debt proceeds are used. There's an exception that allows a longer period of deduction for balloon notes that are refinanced after Oct. 13, 1987.

Points. In general, points that you pay to refinance your home aren't fully deductible in the year that you paid them. Instead, you can deduct a portion of the points each year over the life of the loan.

To figure your deduction for points, divide the total points by the number of payments to be made over the life of the loan. Then, multiply this result by the number of payments you made in the tax year.

For example, if you paid \$3,000 in points and you will make 360 payments on a 30-year mortgage, you can deduct \$8.33 per monthly payment. For a year in which you make 12 payments, you can deduct a total of \$99.96 ($\8.33×12).

However, you may be entitled to a larger first-year deduction for points if you used part of the proceeds of the refinancing to improve your home and you meet certain other requirements. In that case, the points associated with the home improvements may be fully deductible in the year they were paid.

For example, say that you refinance a high-rate mortgage that has an outstanding balance of \$80,000 with a new lower-rate loan for \$100,000. You use the proceeds of the new mortgage loan to pay off the old loan and to pay for \$20,000 of improvements to your home. Since 20% of the new loan was incurred to pay for improvements, 20% of the points you paid can be deducted in the year of the refinancing.

If you are refinancing your mortgage for the second time, the portion of the points on the first refinanced mortgage that you haven't yet deducted may be deductible at the time of the second refinancing.

Penalties and fees. A prepayment penalty that you pay to terminate your old mortgage is deductible as interest in the year of payment.

However, fees paid to obtain the new mortgage aren't deductible, nor can you add them to your basis in your home to reduce the gain when you sell it. Examples of such nondeductible fees are credit report fees, loan origination fees, and appraisal fees.

Overall limit on itemized deductions. The rules that reduce the itemized deductions of taxpayers with adjusted gross income above \$156,400 (above \$78,200 for marrieds filing separately) in 2007 may limit the amount of the above deductions you can take. For 2008, the reduction starts at adjusted gross income above \$159,950 (\$79,975 for marrieds filing separately).