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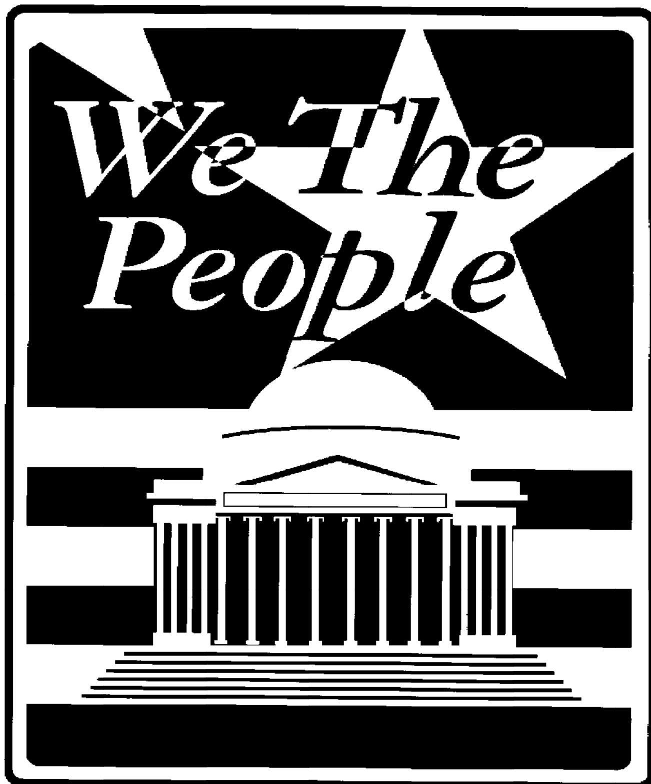
Home Mortgage Interest Deduction

For use in preparing
1994 Returns



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Important Change for 1994

Points paid by seller. You may be able to deduct points paid on your mortgage by the person who sold you your home. See *Points* in *Part I.*

Important Reminders

Personal interest. Personal interest is not deductible. Examples of personal interest include interest charged on credit cards, car loans, and installment plans.

Points shown on Form 1098. The Form 1098, *Mortgage Interest Statement,* you receive will include the amount of points you paid on most mortgage loans during 1994. For more information, see *Points* and *Mortgage Interest Statement,* in *Part I.*

Limit on itemized deductions. Certain itemized deductions (including home mortgage interest) are limited if your adjusted gross income is more than $111,800 ($55,900 if you are married filing a separate return). For more information, see the instructions for Schedule A (Form 1040).

Seller-financed mortgage interest. If you paid home mortgage interest to the person from whom you bought your home, show that person's name, address, and social security number (SSN) or employer identification number (EIN) on the dotted lines next to line 11 of Schedule A (Form 1040).

That person must give you his or her SSN or EIN. You must also give that person your SSN. Failure to do any of these may result in a $50 penalty.

For more information about reporting interest expense, see *Mortgage Interest Statement* in *Part I.* For information about reporting interest income, see Chapter 1 of Publication 550, *Investment Income and Expenses.*

Introduction

This publication discusses the rules for deducting home mortgage interest.

Part I: Home Mortgage Interest contains general information on home mortgage interest. It explains points and the mortgage interest statement.

Part II: Limits on Home Mortgage Interest Deduction explains how your deduction for home mortgage interest may be limited. It contains *Table 1,* which is a worksheet you may have to use to figure a limit on your deduction.

If you apply the proceeds of a debt to more than one use (for example, personal and business), you may have to allocate the interest on the debt to each use in figuring how and where it is deducted. See *Mixed-use mortgages,* later, under the *Table 1 Instructions.* Also see *Allocation of Interest* in Chapter 8 of Publication 535, *Business Expenses.*

Useful Items

You may want to see:

Publication

- ❏ **225** Farmer's Tax Guide
- ❏ **334** Tax Guide for Small Business
- ❏ **527** Residential Rental Property
- ❏ **535** Business Expenses
- ❏ **550** Investment Income and Expenses

Form (and Instructions)

- ❏ **8396** Mortgage Interest Credit

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Part I: Home Mortgage Interest

This part contains general information on home mortgage interest, including points and the mortgage interest statement.

Generally, home mortgage interest is any interest you pay on a loan secured by your home (main home or a second home). These loans include: a mortgage to buy your home, a second mortgage, a line of credit, and a home equity loan.

To deduct home mortgage interest, you must file Form 1040 and itemize deductions on Schedule A. If the interest is deductible home mortgage interest, report it on lines 10–12 of Schedule A.

In most cases, you will be able to deduct all of your home mortgage interest. Whether it is all deductible depends on the date you took out the mortgage, the amount of the mortgage, and your use of its proceeds.

If all of your mortgages fit into one or more of the following three categories, you can deduct ALL of the interest on those mortgages. If any one mortgage fits into more than one category, add the parts of the mortgage that fit in each category to your other mortgages in the same category. If one or more of your mortgages does not fit into any of these categories, use *Part II: Limits on Home Mortgage Interest Deduction,* later in this publication, to figure the amount of interest you can deduct.

The three categories are:

- Mortgages you took out on or before October 13, 1987 (called grandfathered debt).
- Mortgages you took out after October 13, 1987, to buy, build, or improve your home (called home acquisition debt), but only if these mortgages plus any grandfathered debt totaled $1 million or less throughout 1994.
- Mortgages you took out after October 13, 1987, other than to buy, build, or improve your home (called home equity debt), but only if these mortgages totaled $100,000 or less throughout 1994.

If you are married and file a separate return, the home acquisition debt limit is $500,000 and the home equity debt limit is $50,000.

If the total amount of all mortgages exceeds the fair market value of the home, an additional limit may apply. See *Home equity debt limit* under *Home Equity Debt,* in *Part II.*

Note. You cannot deduct home mortgage interest if you use the proceeds of the mortgage to purchase securities or certificates that produce tax-free income.

See *Part II* of this publication for definitions of grandfathered, home acquisition, and home equity debt.

You can use *Figure A* in this publication to check whether your interest is fully deductible.

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

Example. John and Peggy Harris bought a new home on May 4. They sold their old home on May 7. During the year they made home mortgage interest payments of $122 on the old home and $2,864 on the new home. The settlement sheet for the sale of the old home showed $5 interest for the 6–day period in May up to, but not including, the date of sale. Their mortgage interest paid for the year is $2,991 ($122 +$2,864 + $5).

Late payment charge on mortgage payment. You can deduct as home mortgage interest a late payment charge if it was not for a specific service performed by your mortgage holder.

Mortgage prepayment penalty. If you pay off your qualified home mortgage early, you may have to pay a penalty. You can include that penalty as home mortgage interest.

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. Figure the credit on Form 8396, *Mortgage Interest Credit.* If you take this credit, you must reduce your mortgage interest deduction by the amount of the credit.

You figure the credit by multiplying the certificate credit rate shown on the MCC by the lesser of:

1) The interest you paid during the year on your actual loan amount (mortgage), or
2) The interest you paid on the loan amount shown on your MCC.

If the credit rate is more than 20%, your credit is limited to $2,000.

Example. You paid mortgage interest of $3,900. The interest on the loan amount shown on your MCC is also $3,900. Your certificate credit rate is 30% (.30). You reduce your mortgage interest deduction by $1,170 ($3,900 × .30), your allowable credit. You deduct $2,730 ($3,900 – $1,170) as mortgage interest on line 10, Schedule A (Form 1040).

See Form 8396 and Publication 530, *Tax Information for First-Time Homeowners,* for more information on the mortgage interest credit.

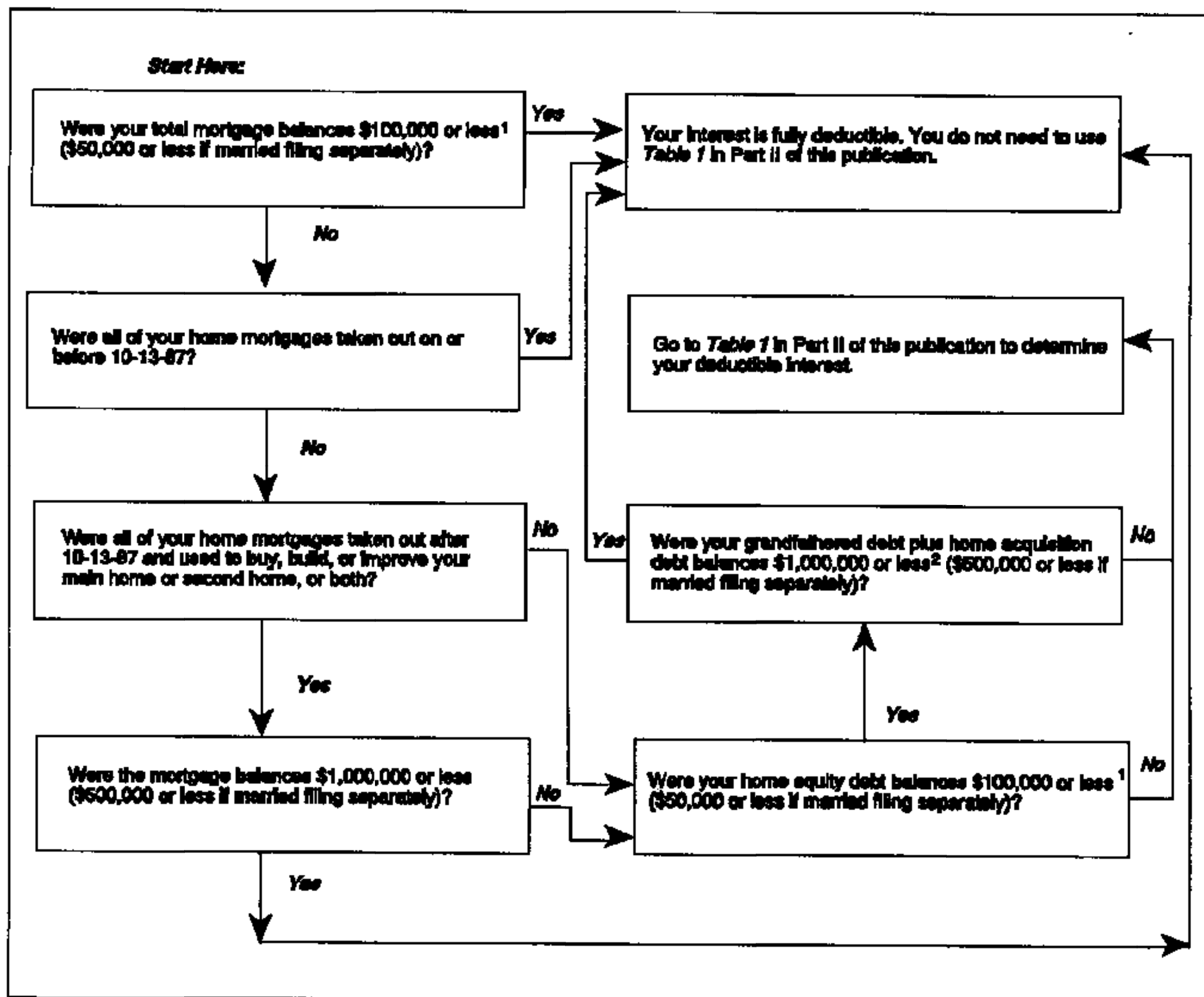
Ministers' and military housing allowance. If you are a minister or a member of the uniformed services and receive a housing allowance that is not taxable, you can still deduct all of the deductible interest on your home mortgage.

Shared appreciation mortgage (SAM). Under a SAM you pay a fixed rate of interest that is less than the prevailing interest rate. You also agree to pay "contingent interest" to the lender. The contingent interest is a percentage of any appreciation in the value of your home and is due upon termination of the SAM. Your monthly payments include interest at the fixed rate. You can deduct this interest, subject to any limits that apply, each year as you pay it if you are a cash basis taxpayer. Generally, a SAM will terminate when you prepay the SAM, sell your home, or on a specified date, whichever is earliest. You can deduct the contingent interest, subject to any limits that apply, in the year you pay it.

If you refinance your loan with the same lender and the face amount of the new loan includes the contingent interest due on the SAM, you are not considered to have paid the contingent interest if you use the cash method of accounting, as most people do. You can deduct

Figure A. Is My Interest Fully Deductible?

(Instructions: Include balances of ALL mortgages secured by your main home and second home. Answer YES only if the answer is true at ALL times during the year.)



1 If all mortgages on your first or second home exceed the home's fair market value, a lower limit may apply. See *Home equity debt limit* in this publication.

2 Amounts over the $1,000,000 limit ($500,000 if married filing separately) qualify as home equity debt if they are not more than the total home equity debt limit. See Part II of this publication for more information about grandfathered debt, home acquisition debt, and home equity debt.

the contingent interest only as you pay off the principal on the new loan. That is, part of the principal in each payment on the new loan is allocated to the contingent interest.

Example. In 1986, you buy your main home for $125,000. You finance the purchase with a 10% 30–year $100,000 SAM that provides that you pay the lender 40% of the appreciation as contingent interest. When you purchased the house the prevailing interest rate was 14%. The contingent interest is due when you pay off the loan, when you sell your home, or in 10 years, whichever is earliest. In 1994, you sell your home for $155,000. You pay off the principal on the mortgage plus $12,000 (40% of the $30,000 appreciation ($155,000 – $125,000)). In 1994, you can deduct the $12,000 contingent interest as home mortgage interest. The result would be the same if you had not sold your house and had paid off the SAM with funds obtained from a source other than the SAM lender.

Graduated payment mortgages (GPM). GPMs under section 245 of the National Housing Act provide that monthly payments increase every year for a number of years and then stay the same. During the early years, payments are less than the amount of interest owed on the loan. The interest that is not paid becomes part of the principal. Future interest is figured on the increased unpaid mortgage loan balance.

Subject to any limits that apply, you can deduct the interest you actually paid during the year if you are a cash method taxpayer. For example, if the interest owed is $2,551 but your payment for the year is $2,517, you can deduct $2,517. Add $34 ($2,551 – $2,517) to the loan principal.

Mortgage assistance payments. If you qualify for mortgage assistance payments 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 any interest that is paid for you. You do not include these payments in your income. These payments do not reduce other deductions, such as taxes.

Redeemable ground rents. In some states (Maryland, for example), you may buy your home subject to a ground rent. A ground rent is an obligation you assume to pay a fixed amount per year on the property. Under this arrangement, you are leasing (rather than buying) the land on which your home is located.

If you make annual or periodic rental payments on a redeemable ground rent, you can deduct them as mortgage interest.

A ground rent is a redeemable ground rent if:

1) The lease of land is for a term of more than 15 years, including renewal periods,
2) You can freely assign the lease,
3) You have a present or future right (under state or local law) to terminate the lease and buy the lessor's entire interest in the land by paying a specific amount, and
4) The lessor's interest in the land is primarily a security interest to protect the rental payments to which he or she is entitled.

Payments made to terminate the lease and to buy the lessor's entire interest in the land are not ground rents. You cannot deduct them.

Nonredeemable ground rent. Payments on a nonredeemable ground rent are not interest. You can deduct them as rent if they are a business expense or if they are for rental property held to produce income.

Reverse mortgage loans. A reverse mortgage loan is a loan that is based on the value of your home and is secured by a mortgage on your home. The lending institution pays you the loan in installments over a period of months or years. The loan agreement may provide that interest will be added to the outstanding loan balance monthly as it accrues. If you are a cash method taxpayer, you deduct the interest on a reverse mortgage loan when you actually pay it, not when it is added to the outstanding loan balance.

Refunds of interest. If you receive a refund of interest in the same year you pay it, you must 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. However, you only need to include the amount of the deduction that reduced your tax in the earlier year.

If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098, *Mortgage Interest Statement,* showing the refund in box 3. For information about Form 1098, see *Mortgage Interest Statement*, later.

For more information on how to treat refunds of interest deducted in earlier years, see *Recoveries* in Publication 525, *Taxable and Nontaxable Income.*

Cooperative apartment owner. If you own a cooperative apartment, you must reduce your 1994 mortgage interest deduction by your share of any cash portion of a patronage dividend that is a refund to the cooperative housing corporation of mortgage interest it paid before 1994.

Closing costs. Expenses that you pay at settlement or closing in connection with buying your home, such as commissions, abstract fees, and recording fees, are capital expenses. You cannot deduct these expenses either as interest or as current business expenses. Add these to the basis of the property.

There are certain settlement fees or closing costs that you cannot deduct or add to the basis of your property. These include:

1) Fire insurance premiums,
2) FHA mortgage insurance premiums and VA funding fees,
3) Charges for utilities or other services related to occupancy of the house before closing,
4) Rent for occupancy before closing,
5) The cost of repairs, and
6) Any item that you deducted as a moving expense (settlement fees and closing costs incurred after 1993 cannot be deducted as moving expenses).

Basis. Generally, your "basis" is what you paid for your home. You use your adjusted basis to figure gain or loss on the sale of your home. If you need more information about basis, see *Basis* in Publication 523, *Selling Your Home.*

Points

The term "points" is used to describe certain charges paid, or treated as paid, by a borrower to obtain a home mortgage. The term also describes certain charges that a home seller pays to a lender for the buyer's mortgage. Points may also be called loan origination fees, maximum loan charges, loan discount, or discount points.

General rule. You cannot deduct the full amount of points in the year paid. You must spread the points over the life (term) of the mortgage. Generally, you can deduct an equal portion in each year of the mortgage.

Exception 1. You can fully deduct in 1994 the amount paid on your loan as points if all the following are true:

1) Your loan is secured by your main home. (Your main home is the one you live in most of the time.)
2) Paying points is an established business practice in the area where the loan was made.
3) The points paid were not more than the points generally charged in this area.
4) You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them. Most individuals use this method.
5) You use your loan to buy or improve your main home.
6) The points were for the use of money, not for other services.
7) The points were paid with funds you did not borrow from your lender or mortgage broker.

Exception 2. You can fully deduct in 1994 the amount paid on your loan as points if all the following are true:

1) Statements (1) through (4) under *Exception 1* are true.
2) You use your loan to buy your main home.
3) The points were computed as a percentage of the principal amount of the mortgage.
4) The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
5) The amount is clearly shown on the settlement statement (for example, Form HUD–1) as points charged for the mortgage. The points may be shown as paid from either your funds or the seller's.
6) At least one of the following is true:
   a) You pay an amount from your own funds that is at least as much as the points. This amount may not be borrowed from your lender or mortgage broker. You do not have to pay the points with these funds. You can apply the funds to a down payment, escrow deposit, or earnest payment, or pay them over for any purpose at the closing.
   b) The points were paid by the seller, and you reduce your basis in the home by the amount of seller-paid points. (See *Basis,* earlier.)

Funds provided are less than points. If you meet all the tests in *Exception 2* except that the funds you provided were less than the points, you can deduct the points in the year paid up to the amount of funds you provided. In addition, you can deduct any points paid by the seller.

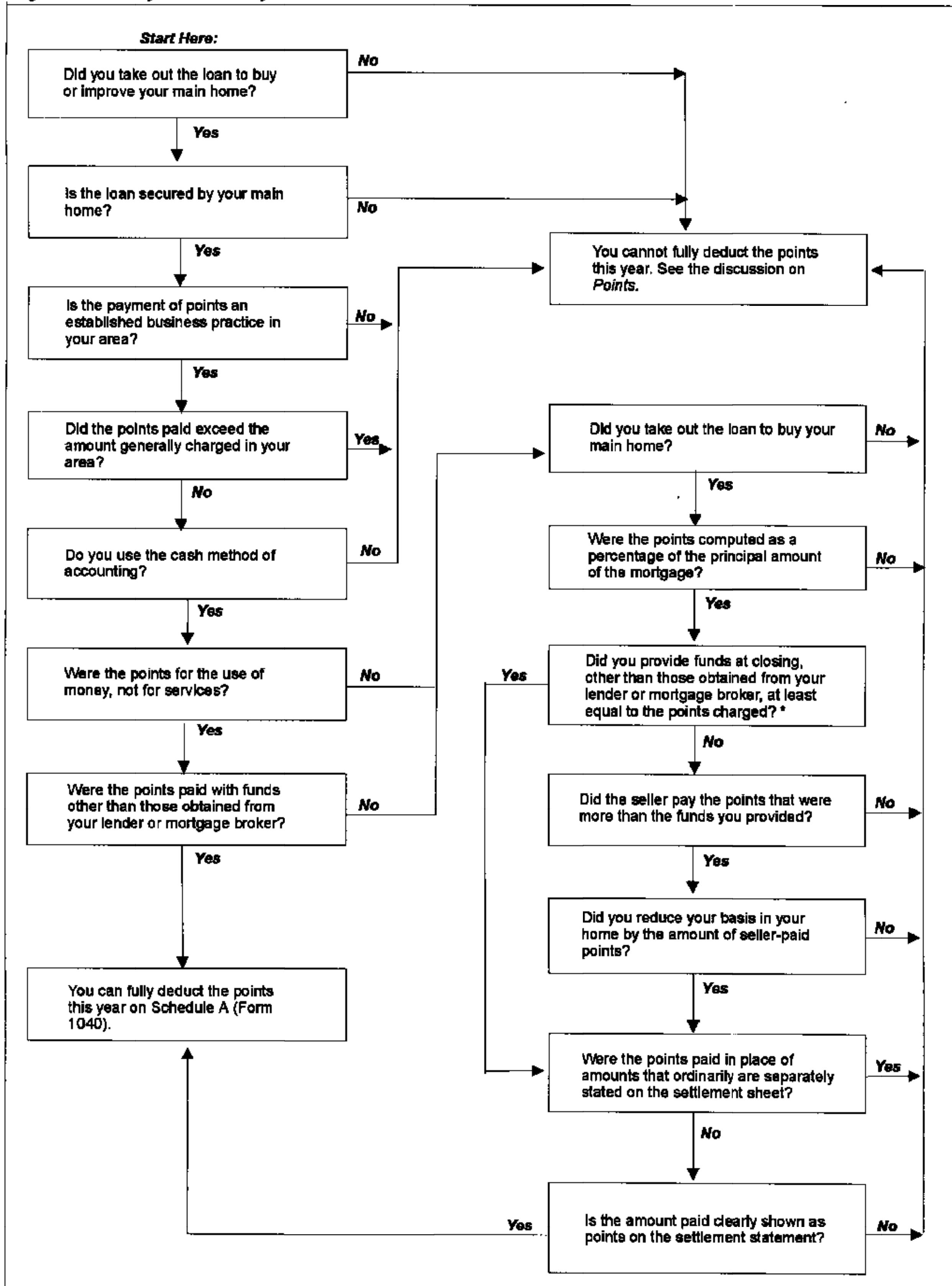
Example 1. When you took out a $100,000 mortgage loan to buy your home in December 1994, you were charged one point ($1,000). You meet all the tests for deducting points in *Exception 2* except the only funds you provided were a $750 down payment. Of the $1,000 charged for points, you can deduct $750 in 1994.

Example 2. The facts are the same as in Example 1, except that the person who sold you your home also paid one point ($1,000) to help you get your mortgage. In 1994, you can deduct $1,750 ($750 of the amount you were charged plus the $1,000 paid by the seller). You must reduce the basis of your home by the $1,000 paid by the seller.

Note. *Exception 2* also applies to a loan origination fee charged for services for getting a conventional, VA, or FHA loan to buy your main home.

Figure B. You can use *Figure B* as a quick check to see if points are fully deductible in the year paid.

Figure B. **Are My Points Fully Deductible This Year?**



* The funds you provide do not have to be applied to the payment of points. They can be applied as down payments, escrow deposits, earnest money applied at the closing, and funds actually paid at closing.

Form 1098. You should receive a Form 1098, *Mortgage Interest Statement,* or a similar statement from your lender or mortgage broker by January 31, 1995. It will show not only the interest you paid, but also any deductible points you paid in 1994 to get a loan to buy your main home. You also may be entitled to a deduction for other points that you paid, but which your lender is not required to include on Form 1098 (such as points paid on a loan used to improve your main home).

Excess points. If the points paid were more than generally paid in your area, your deduction in 1994 is limited to the points generally charged. Any additional amount of points paid is interest paid in advance and the deduction must be spread over the life of the mortgage.

Second home. The exceptions do not apply to points you pay on loans secured by your second home. You can deduct these points only over the life of the loan.

Mortgage ending early. If you spread your deduction for points over the life of the mortgage, you can deduct any remaining balance in the year the mortgage ends. A mortgage may end early due to a prepayment, refinancing, foreclosure, or similar event.

Example. Dan refinanced his mortgage in 1989 and paid $3,000 in points that he had to spread out over the life of the mortgage. He had deducted $1,000 of these points through 1993.

Dan prepaid his mortgage in full in 1994. He can deduct the remaining $2,000 of points in 1994.

Refinancing. Generally, points you pay to refinance a mortgage are not deductible in full in the year you pay them. This is true even if the new mortgage is secured by your main home.

However, if you use part of the refinanced mortgage proceeds to ***improve your main home*** and you meet the seven conditions listed under *Exception 1,* earlier, you can fully deduct the part of the points related to the improvement in the year paid. You can deduct the remainder of the points over the life of the loan.

Example 1. In 1988, Bill Fields obtained a mortgage for the purchase of a home. The interest rate on that mortgage loan was 11%. On June 1, 1994, Bill refinanced this mortgage with a 15–year $100,000 mortgage loan that has an interest rate of 8%. In order to obtain the financing, he had to pay three points ($3,000). The fees represented two points ($2,000) for prepaid interest and one point ($1,000) for loan fees charged for the lender's services. Bill paid the points out of his private funds, rather than out of the proceeds of the new loan. The payment of points is an established practice and the points charged do not exceed the amount generally charged in the area. Bill made six payments on the loan in 1994 and is a cash basis taxpayer.

Bill used the funds obtained from the new mortgage to repay his existing mortgage. Although the new mortgage loan was incurred in connection with Bill's continued ownership of his main home, it was not incurred in connection with the purchase or improvement of that home. For that reason, Bill cannot deduct all of the points in 1994. He can deduct two points ($2,000) ratably over the life of the loan. He deducts $67 (($2,000 ÷ 180 months) × 6 payments) of the points on his 1994 return (on line 12, Schedule A). The other point ($1,000) was a fee for services and not deductible.

Example 2. The facts are the same as in Example 1, except that Bill used $25,000 of the loan proceeds to ***improve his home*** and $75,000 to repay his existing mortgage. Because he paid the points out of his private funds, he is allowed to deduct 25% ($25,000 ÷ $100,000) of the two points that represent prepaid interest. His deduction for the part of the prepaid interest that is for his home improvement is $500 ($2,000 prepaid interest × 25%).

Additionally, in 1994, Bill can deduct the ratable part of the $1,500 ($2,000 prepaid interest – $500 for home improvement) that must be spread over the life of the loan. He can deduct $50 of the ratable part of the prepaid interest in 1994 (($1,500 ratable part of prepaid interest ÷ 180 months life of the loan) × 6 payments made in 1994 = $50). The total amount deductible in 1994, on line 12, Schedule A, is $550 ($500 + $50). If Bill makes all of his payments when due, his annual deduction will be $100 each year for 1995 through 2008 (($1,500 ÷ 180 months) × 12 payments = $100). His deduction in 2009, the final year of payment, will be $50 because he will make six payments that year.

Amounts charged for specific services by the lender for the borrower's account are not interest. Examples of fees for services not considered interest are the lender's appraisal fee, preparation costs for the mortgage note or deed of trust, settlement fees, and notary fees. An amount listed on your settlement statement as a loan origination fee is interest, even if it is charged for the lender's services, but only if the amount otherwise falls within *Exception 2,* earlier.

Points paid by the seller. The term "points" includes loan placement fees that the seller may have to pay to the lender to arrange financing for the buyer. The seller ***cannot*** deduct these amounts as interest. But these charges are a selling expense that reduce the seller's amount realized. The buyer may be able to deduct the seller-paid points, as explained earlier in this discussion.

Points paid by seller in 1991, 1992, or 1993. You can deduct seller-paid points on an amended return, if:

1) The person who sold you your home paid points for your mortgage in 1991, 1992, or 1993,
2) You did not deduct the points on your original return for the year paid, and
3) You meet the tests for deducting the points described under *Exception 1* or *Exception 2,* earlier.

File an amended return for the year the points were paid. Use Form 1040X, *Amended U.S. Individual Income Tax Return.* Write "Seller-Paid Points" in the top right margin of the amended return and attach a copy of the settlement statement (for example, Form HUD–1) showing the points.

Generally, you must file the amended return within 3 years from the date your original return was filed or within 2 years from the date the tax was paid, whichever is later. For details, get Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund.*

Limits on deduction. You cannot fully deduct points paid on a mortgage that exceeds the limits discussed in *Part II.* See *Table 1 Instructions,* in *Part II.*

Mortgage Interest Statement

If you paid mortgage interest of $600 or more during the year on any one mortgage, you generally will receive a Form 1098, *Mortgage Interest Statement,* or a similar statement. You will receive the statement if you pay interest to a person (including a financial institution or cooperative housing corporation) in the course of that person's trade or business. A governmental unit is a person for purposes of furnishing the statement.

The statement will show the total interest you paid during the year. If you purchase a main home during 1994, it also will show the deductible points you paid during the year. However, it should not show housing assistance payments under section 235 of the National Housing Act.

If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098 showing the refund in box 3. See *Refunds of interest*, earlier.

Note. Form 1098 will not include points paid for:

1) Home improvement loans on your main home,
2) Purchase or home improvement loans on your second home, vacation property, investment property, or trade or business property,
3) Refinancing, home equity loans, and lines of credit secured by your main home, and
4) Amounts that are more than the points generally charged in your area.

However, certain points not included on Form 1098 may be deductible. See the earlier discussion of *Points* for more information.

You should receive the statement by January 31, 1995. The mortgage interest information will also be sent to the IRS.

Caution: If you prepaid interest in 1994 that accrued in full by January 15, 1995, this prepaid interest may be included in box 1 of Form 1098. However, even though the prepaid

amount may be included in box 1, you cannot deduct the prepaid amount in 1994. You will have to figure the interest that accrued for 1995 and subtract it from the amount in box 1. You will include the interest for 1995 with other interest you pay for 1995.

How To Report

If mortgage interest is fully deductible home mortgage interest, deduct the interest and the points reported to you on Form 1098 on line 10, Schedule A (Form 1040).

Deduct fully deductible home mortgage interest that was ***not*** reported to you on Form 1098 on line 11 of Schedule A (Form 1040). If you paid home mortgage interest to the person from whom you bought your home, show that person's name, address, and social security number (SSN) or employer identification number (EIN) on the dotted lines next to line 11. The seller must give you this number and you must give the seller your SSN. Failure to meet any of these requirements may result in a $50 penalty for each failure.

Deduct points paid on a mortgage that were ***not*** reported to you on Form 1098 on line 12 of Schedule A (Form 1040).

If the mortgage interest is not fully deductible home mortgage interest but you used the proceeds of the loan for other purposes, then you may be able to deduct it as investment, business, or passive activity interest, subject to the rules for those deductions. *Table 2,* later in this publication, shows where to deduct various kinds of interest expense.

If your home mortgage interest payments are more than the amount shown on the mortgage interest statement, you can deduct the amount of the interest that you ***actually paid.*** Attach a statement to your tax return explaining why you are deducting more than the amount reported on Form 1098. The interest must be for the tax year you are claiming the deduction. If you paid interest in 1994 that includes amounts that apply to any period after 1994, you may deduct only the amount that applies to 1994.

You can deduct only your share of the mortgage interest you paid. If your mortgage payments were subsidized by a government agency, do not deduct the amount paid for you.

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 1994, attach a statement to your return explaining this, showing how much of the interest each of you paid, and giving the name and address of the person who received the form. In the far left margin, next to line 11, Schedule A, write "see attached."

Similarly, if you are the payer of record on a mortgage on which there are other borrowers entitled to a deduction for the interest shown on the Form 1098 you received, you should furnish the other borrowers with information about the proper distribution of the amounts shown on the form you received.

Part II: Limits on Home Mortgage Interest Deduction

This part discusses the limits you may have to figure on your home mortgage interest deduction. It also explains how to figure these limits.

If all of your mortgages fit into one or more of the following three categories, you can deduct ALL of the interest and these limits do not apply. If any one mortgage fits into more than one category, add the parts of the mortgage that fit in each category to your other mortgages in the same category. If one or more of your mortgages does not fit into any of these categories, use this part to figure the amount of interest you can deduct.

The three categories are:

- Mortgages you took out on or before October 13, 1987 (called grandfathered debt).
- Mortgages you took out after October 13, 1987, to buy, build, or improve your home (called home acquisition debt), but only if these mortgages plus any grandfathered debt totaled $1 million or less throughout 1994.
- Mortgages you took out after October 13, 1987, other than to buy, build, or improve your home (called home equity debt), but only if these mortgages totaled $100,000 or less throughout 1994.

If you are married and file a separate return, the home acquisition debt limit is $500,000 and the home equity debt limit is $50,000.

If the total amount of all mortgages exceeds the fair market value of the home, an additional limit may apply to your home equity debt. See *Home equity debt limit* under *Home Equity Debt,* later.

Secured Debt

You can deduct your home mortgage interest only if your mortgage is a secured debt. A secured debt is one in which you sign an instrument (such as a mortgage, deed of trust, or land contract) that:

1) Makes your ownership in a qualified home security for payment of the debt,
2) Provides, in case of default, that your home could satisfy the debt, and
3) Is recorded or is otherwise perfected under any state or local law that applies.

In other words, your mortgage is a secured debt if you put your home up as collateral to protect the interests of the lender. If you cannot pay the debt, your home can then serve as payment to the lender to satisfy (pay) the debt. In this publication ***mortgage*** will refer to secured debt.

Debt not secured by home. A debt is not secured by your home if it is secured solely because of a lien on your general assets or if it is a security interest that attaches to the property without your consent (such as a mechanic's lien or judgment lien).

Wraparound mortgage. This is not a secured debt unless it is recorded or otherwise perfected under state law.

Example. Beth owns a home subject to a mortgage of $40,000. She sells the home for $100,000 to John, who takes it subject to the $40,000 mortgage. Beth continues to make the payments on the $40,000 note. John pays $10,000 down and gives Beth a $90,000 note secured by a wraparound mortgage on the home. Beth does not record or otherwise perfect the $90,000 mortgage under applicable state law. Therefore, that mortgage is not a secured debt, and the interest John pays on it is not home mortgage interest.

Choice to treat the debt as not secured by your home. You can choose to treat any debt secured by your qualified home as not secured by the home. This treatment begins with the tax year for which you make the choice and continues for all later tax years. You may revoke your choice only with the consent of the Internal Revenue Service (IRS).

You may want to treat a debt as not secured by your home if the interest on that debt is fully deductible whether or not it qualifies as home mortgage interest. This may allow you more of a deduction for interest on other debts that are deductible only as home mortgage interest.

Qualified Home

For you to take a home mortgage interest deduction, your debt must be secured by a qualified home. This means your main home or your second home. A home includes a house, condominium, cooperative, mobile home, boat, or similar property that has sleeping, cooking, and toilet facilities.

Main home. You can have only one main home at any one time. Generally, this is the home where you spend most of your time.

If you sold this home, you could qualify to postpone paying tax on any gain. For information on the sale of your main home, see Publication 523, *Selling Your Home.*

Second home. If you have a second home that you do not rent to others, you can treat it as a qualified home. It does not matter whether you use the home during the year.

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

If you have more than one second home, you can treat only one as the qualified second home during any year. However, an exception is made to this rule in the following three situations.

1) 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.

2) If your main home no longer qualifies as your main home, you can choose to treat it as your second home as of that date.
3) If your second home is sold during the year or becomes your main home, you can choose a new second home as of that date.

The interest you pay on a home other than your main or second home may be deductible if the proceeds of the loan were used for business or investment purposes. Otherwise, it is considered personal interest and is not deductible.

Divided use of your home. The only part of your home that is considered a qualified home is the part you use for residential living. You must divide both the cost and fair market value of your home between the part that is a qualified home and the part that is not. Dividing the cost may affect the amount of your home acquisition debt, which is limited to the cost of your home plus the cost of any improvements. (See *Home Acquisition Debt,* later.) Dividing the fair market value may affect your home equity debt limit, explained later.

If you have an office in your home that you use in your business, there are special rules. See Publication 587, *Business Use of Your Home,* for more information.

If you rent out part of a qualified home to another person (tenant), you can treat the rented part as being used by you for residential living only if **all** three of the following conditions apply.

1) You rent out part of your home that the tenant uses primarily for residential living.
2) The rented part of your home is not a self-contained residential unit having separate sleeping, cooking, and toilet facilities.
3) You do not rent (directly or by sublease) to more than two tenants at any time during the tax year. If two persons (and dependents of either) share the same sleeping quarters, they are treated as one tenant.

Home under construction. You can treat a home under construction as a qualified home for a period of up to 24 months, but only if it becomes your qualified home at the time it is ready for occupancy.

The 24–month period can start any time on or after the day construction actually begins.

Time-sharing arrangements. If you own a home under a time-sharing plan, you may be able to treat it as a qualified home. 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 portion of the year.

Your time-share qualifies if it meets all the other requirements for a qualified home. This includes the use requirements for renting your second home. However, you only count your use and rental of the home during the time you have a right to use it.

Married taxpayers. If you are married and file a joint return, your qualified homes can be owned either jointly or by only 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, you can both consent in writing that one spouse can take the main home and a second home into account.

Home Acquisition Debt

Home acquisition debt is a mortgage you took out after October 13, 1987, to buy, build, or substantially improve your main or second home. It also must be secured by that home. The amount of this debt cannot be more than the cost of the home plus the cost of any improvements. Your home acquisition debt amount is decreased as you pay off the principal on your loan.

Each test for home acquisition debt is independent of the other tests. For example, a debt that you use to buy, build, or substantially improve your home, may not qualify as home acquisition debt because it is not secured by the property. Similarly, interest on a mortgage for property that is not a qualified home is not deductible as home mortgage interest. However, if the property later becomes a qualified home or the debt is later secured by the home, interest on the mortgage after that time may qualify.

Refinanced home acquisition debt. Any secured debt you use to refinance home acquisition debt is treated as home acquisition debt. However, the new debt will qualify as home acquisition debt only up to the amount of the balance of the old mortgage principal just before the refinancing. Any amount over that is not considered home acquisition debt, but may qualify as home equity debt (discussed later).

Home acquisition debt limit. The total amount of home acquisition debt you can have at any time cannot be more than $1 million ($500,000 if married filing separately). However, this limit is reduced (but not below zero) by the amount of your grandfathered debt, discussed later. Amounts over this limit, up to $100,000 ($50,000 if married filing separately), may qualify as home equity debt.

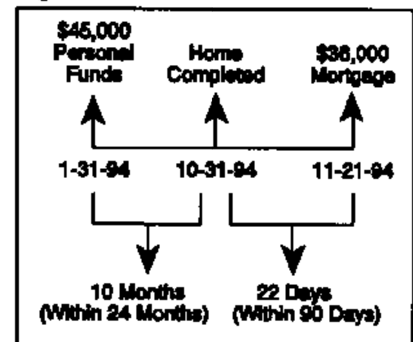
When mortgage must be taken out. To be treated as home acquisition debt, a mortgage must be secured by a qualified home and must be taken out within one of the following time periods. The total amount of debt which may be treated as home acquisition debt may not be more than the cost of the home (including the cost of any substantial improvements).

1) You buy your home within 90 days before or after the date you take out your mortgage.
2) You build or improve your home and take out a mortgage before the work is completed. The home acquisition debt is limited to the amount of the expenses incurred within 24 months before the date of the mortgage.
3) You build or improve your home and take out a 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.

Example 1. You bought your main home on June 3, 1994, for $175,000. You paid for the home with cash you got from the sale of your old home. On July 15, 1994, you took out a mortgage of $150,000 secured by your main home. You used the $150,000 to invest in stocks. You can treat the mortgage as taken out to buy your home because you bought the home within 90 days before you took out the mortgage.

Example 2. On January 31, 1994, John began building a home on the lot that he owned. He used $45,000 of his personal funds to build the home. The home was completed on October 31, 1994. John took out a mortgage of $36,000, on November 21, 1994, that was secured by the home. The entire mortgage can be treated as home acquisition debt because it was taken out within 90 days after the home was completed and it was less than the expenses incurred within the period beginning 24 months before the home was completed. *Figure C* illustrates this.

Figure C.



Date of the mortgage. The date you take out your mortgage is the day you receive the loan proceeds, generally the closing date. You can treat the day you apply in writing for your mortgage as the date you take it out. However, this applies only if you receive the loan proceeds within 30 days after your application is approved. If an application you make within the 90–day period is rejected, a reasonable additional time will be allowed to make a new application.

Costs of home or improvements. To determine your cost, include amounts paid to acquire any interest in a qualified home.

Acquiring an interest in a home because of a divorce. Cost includes amounts spent to acquire the interest of a spouse or former spouse in a home, because of a divorce or legal separation.

Building costs. These include costs to construct a qualified home, including costs to acquire real property and building materials, fees for architects and design plans, and required building permits.

Substantial improvement costs. These include any costs to substantially improve a qualified home, including costs to acquire real property and building materials, fees for architects and design plans, and required building permits. An improvement is substantial if it:

Adds to the value of your home,

Prolongs your home's useful life, or

Adapts your home to new uses.

The cost of repairs that maintain your home in good condition, such as repainting your home, cannot be added to the basis of the property. However, if you paint your home as part of a renovation that substantially improves your qualified home, you can add the painting costs to the basis of your property.

Home Equity Debt

If you take out a loan for reasons other than to buy, build, or substantially improve your home, it may qualify as home equity debt.

Home equity debt is a mortgage you took out after October 13, 1987. It is a debt, other than grandfathered debt, discussed later, or home acquisition debt, that is secured by your qualified home.

Interest on amounts over the home equity debt limit, discussed next, generally is treated as personal interest and is not deductible.

Note. If the proceeds of the loan were used for investment or business purposes, the interest may be deductible. See *Allocation of Interest* in Chapter 8 of Publication 535, *Business Expenses.*

Home equity debt limit. There is a limit on the amount of debt that can be treated as home equity debt. The debt is limited to the ***smaller*** of:

1) $100,000 ($50,000 if married filing separately), or
2) The fair market value (FMV) of the home minus the home acquisition debt (including grandfathered debt). Determine the FMV and the outstanding home acquisition debt on the date that the last debt was secured by the home.

If you have a main home and second home, to determine the FMV in (2) above, figure the FMV of each home as of the date the last debt was secured by the home and then add the two amounts.

When you figure the limit on your home equity debt, you must divide the FMV of your home between the part that is a qualified home and any part that is not a qualified home.

Fair market value. This is the price at which the home would change hands between you and a buyer, neither having to sell or buy, and both having reasonable knowledge of all necessary facts. Sales of similar homes in your area, on about the same date you secure your last debt on the home, may be helpful in figuring the FMV.

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. If it qualifies, treat it as home acquisition debt. However, it is not subject to the $1 million limit on other home acquisition debt.

For any new home acquisition debt you take out after October 13, 1987, the $1 million limit does apply. However, this limit is reduced (but not below zero) by the amount of your grandfathered debt.

Refinanced grandfathered debt. If you refinance grandfathered debt after October 13, 1987, for an amount that is not more than the mortgage principal left on the debt, then you still treat it as grandfathered debt. However, any amount that is more than that mortgage principal is treated as home acquisition or home equity debt, and the mortgage is a mixed-use mortgage (discussed later). The debt must be secured by the qualified home.

You treat grandfathered debt that was refinanced after October 13, 1987, as grandfathered debt only for the term left on the debt being refinanced. After that, you treat it as home acquisition debt or home equity debt, depending on how you used the proceeds.

Exception. If the debt before refinancing is like a balloon note (the principal on the debt is not amortized over the term of the debt), then you treat the refinanced debt as grandfathered debt for the term of the first refinancing. This term cannot be more than 30 years.

Example. Chester acquired a $200,000 first mortgage on his home in 1985. The mortgage was a five-year balloon note and the entire balance on the note was due in 1990. Chester refinanced the debt in 1990 with a new 20-year mortgage. The refinanced debt is treated as grandfathered debt for its entire term (20 years).

Line-of-credit mortgage. If you had a line-of-credit mortgage on October 13, 1987, and borrowed additional amounts against it after that date, then the additional amounts are either home acquisition debt or home equity debt depending on how you used the proceeds. The balance on the mortgage before you borrowed the additional amounts is grandfathered debt. The newly borrowed amounts are not grandfathered debt because the funds were borrowed after October 13, 1987. See *Mixed-use mortgages* under *Table 1 Instructions,* next.

Table 1 Instructions

If ALL of your mortgages secured by your main home or second home are within the limits discussed earlier in *Part II* for the entire year, you can deduct ALL of the interest. You do not have to complete *Table 1* in this publication. Otherwise, use *Table 1* to determine your qualified loan limit and deductible home mortgage interest. Fill out only one *Table 1,* for both your main and second home, regardless of how many mortgages you have on your main home or second home.

Note. If you took out a mortgage after October 13, 1987, and parts of the mortgage are within more than one of the three categories of debt (home equity debt, grandfathered debt, or home acquisition debt), it is a mixed-use mortgage. If the mixed-use mortgage added to your other home mortgages exceeds the qualified loan limits on home acquisition debt and home equity debt, be sure to read the discussion on *Mixed-use mortgages* later in this section.

If you have only home equity debt that you took out after October 13, 1987, do not fill in lines 1 through 5. Enter zero on line 6 and complete the rest of the worksheet.

Average Mortgage Balance

If you have mortgages secured by a qualified home, you have to figure the average balance of each mortgage to determine your qualified limit. You need these amounts to complete lines 1, 2, and 9 of the worksheet. You can use the highest mortgage balances during the year to complete the worksheet, but you may benefit most by using the average balances. The following are methods you can use to figure your average mortgage balances. However, if you have a mixed-use mortgage, also see *Mixed-use mortgages* later in this section.

Average of first and last balance method. You can use this method if all the following apply.

1) You did not borrow any new amounts on the mortgage in 1994.
2) You did not prepay more than one month's principal during 1994.
3) You had to make level payments at fixed equal intervals on at least a semi-annual basis. You treat your payments as level even if they were adjusted from time to time because of changes in the interest rate.

To figure your average balance, complete the following.

1. Enter the balance as of the first day that the mortgage was outstanding in 1994 (generally January 1, 1994) ________
2. Enter the balance as of the last day that the mortgage was outstanding in 1994 (generally December 31, 1994) .... ________
3. Add amounts on lines 1 and 2 ..... ________
4. Divide the amount on line 3 by 2. Enter the result .... ________

Debt was secured and outstanding only part of the year. If your debt was a secured debt and outstanding debt for less than the entire tax year, figure your average balance as follows. Multiply the amount on line 4, above, by the number of months in 1994 that the debt was secured and outstanding. Divide the result by 12.

Interest paid divided by interest rate method. You can use this method if at all times in 1994 the mortgage was secured by your qualified home and the interest was paid at least monthly. Complete the following worksheet to figure your average balance.

1. Enter the interest paid in 1994. Do not include points. However, do include other prepaid interest that was due in 1994. Do not include prepaid interest for other years until the year due. ..... ________
2. Enter the annual interest rate on the mortgage. If the interest rate varied in 1994, use the lowest rate for the year ________
3. Divide the amount on line 1 by the amount on line 2. Enter the result ..... ________

Example. Mr. Blue had a line of credit secured by his main home all of 1994. He paid interest of $2,500 (line 1 of the worksheet) on this loan. The interest rate on the loan (line 2) was 9% (.09) throughout the year. His average balance using this method (line 3) is $27,778 ($2,500 ÷ .09).

1. Enter the interest paid in 1994. Do not include points. However, do include other prepaid interest that was due in 1994. Do not include prepaid interest for other years until the year due. $2,500
2. Enter the annual interest rate on the mortgage. If the interest rate varied in 1994, use the lowest rate for the year .09
3. Divide the amount on line 1 by the amount on line 2. Enter the result $27,778

Statements provided by your lender. If you receive monthly statements showing the closing balance or the average balance for the month, then you can use either to figure your average balance. You can treat the balance as zero for any month the mortgage was not outstanding.

Figure your average balance by adding your monthly closing or average balances and dividing that total by 12. If your lender can give you your average balance for 1994, you can use that amount.

Example. Ms. Brown had a home equity loan secured by her main home for all of 1994. She received monthly statements showing her average balance for each month. She may figure her average balance for 1994 by adding her monthly average balances and dividing the total by 12.

Mixed-use mortgages. If you have a mortgage secured by a qualified main home or second home that is allocable to more than one of the three categories of debt (i.e., home equity debt, grandfathered debt, and home acquisition debt), you have a mixed-use mortgage. For example, if you took out a mortgage after October 13, 1987, and used part of it to refinance home acquisition debt and part of it for purposes other than to buy, build or substantially improve your home, it is a mixed-use mortgage.

In order to figure the average balances of a mixed-use mortgage to complete line 1 of *Table 1* for grandfathered debt and line 2 of *Table 1* for home acquisition debt, you will need to use the following procedure.

1) You must determine the amount of the mixed-use mortgage proceeds that is within each of the three categories of debt. This depends on how you actually used the funds. For example, assume you refinance grandfathered debt of $800,000 and borrow an additional $500,000 in this same loan, using $300,000 to do substantial home improvements and $200,000 to purchase an exotic used car. When you first take out the mixed-use mortgage, $800,000 is grandfathered debt, $300,000 is home acquisition debt, and $200,000 is home equity debt.

2) Each year as your mortgage payments reduce the principal balance of the mixed-use mortgage, you must allocate your principal payments to the three categories of debt in the following order.

   a) Home equity debt

   b) Grandfathered debt

   c) Home acquisition debt

Allocate these payments to the first type of debt listed that applies to your mortgage. The payment allocation reduces the principal amount of that part of the loan by the amount allocated. Once you have reduced that debt balance to $0, allocate your payments to the next type of debt, and so forth. For example, if you make principal payments on a mortgage that you had used for both substantial home improvements and to pay off your credit card balance, your payments would first reduce the balance of the home equity debt. (In this case, your home equity debt is that part of the mortgage proceeds used to pay off your credit card balance.) Once that part of the mortgage balance is reduced to $0, whether in this year or a future year, allocate your payments to the home acquisition debt. (In this case, your home acquisition debt is that part of the mortgage proceeds used for substantial home improvements).

3) In order to figure the average balance of grandfathered debt, for line 1 of *Table 1*, you must determine the monthly balance for each month. Add the monthly balances for each month for the grandfathered portion of the debt and divide the result by 12. Enter the result on line 1 of *Table 1.* For line 2 of *Table 1*, follow the same method for figuring the average balance for home acquisition debt, if any, after you have reduced any grandfathered debt to $0.

Example 1. In 1986, Sharon took out a $1,400,000 mortgage to purchase her main home. She filed as single for 1994. In March 1994, when the home had a fair market value of $1,700,000 and she owed $1,100,000 on the mortgage, she took out a second mortgage for $200,000 which she put to mixed uses. Sharon used $180,000 of the proceeds for substantial home improvements, and $20,000 for other purposes. The loan agreement states that she must make principal payments of $1,000 per month. During 1994, her principal payments on the second mortgage totaled $10,000.

Sharon uses *Table 1* to figure her qualified loan limit and deductible home mortgage interest for 1994. She determines the average 1994 balance of her first mortgage (grandfathered debt) using one of the methods listed earlier in this discussion and enters it on line 1 of *Table 1.* She then figures the average balance of the home acquisition part of the mixed-use mortgage. She determines the beginning balance of the home acquisition debt to be $180,000. Sharon does not allocate any principal payments to the home acquisition debt because the entire $10,000 of principal payments on the second mortgage is allocable to the home equity debt. She adds the March through December monthly balances of the home acquisition debt (each monthly balance is $180,000 in this case) and divides the result by 12 to determine the average balance is $150,000 ($1,800,000 ÷ 12 = $150,000). She enters $150,000 on line 2 of *Table 1.*

Example 2. The situation is the same as in Example 1, except Sharon is now figuring her qualified loan limit and deductible home mortgage interest for 1995. During 1995, her principal payments on the second mortgage totaled $12,000, of which she must allocate $10,000 to the home equity part of the loan and $2,000 to the home acquisition part of the loan. This makes her 1995 ending balance for the home equity debt part of the second mortgage $0 ($20,000 1994 beginning balance − $10,000 1994 allocation − $10,000 1995 allocation), and makes her 1995 ending balance for the home acquisition debt part of the loan $178,000 ($180,000 1994 beginning balance − $2,000 1995 allocation).

Sharon determines the average 1995 balance of her first mortgage using one of the methods listed earlier in this discussion and enters it on line 1 of *Table 1.* This year she also has to figure the average 1995 balance of the home acquisition debt because it changed from $180,000 to $178,000 during the year. It took 10 months of 1995 to reduce the home equity part of the second mortgage to $0

($1,000 × 10 months = $10,000). During these months, the home acquisition debt balance remained at $180,000. Her last two payments for 1995 reduced the home acquisition debt balance to $179,000 in November and to $178,000 at year end. Sharon computes the average balance of her home acquisition debt as follows.

$180,000	balance 1/1/95
× 10	months
$1,800,000	
+ 179,000	November balance
+ 178,000	year end balance
$2,157,000	
÷ 12	monthly payments
$179,750	average balance

She enters $179,750 on line 2 of *Table 1.*

The following table shows how Sharon's principal payments, on her second mortgage, in the two previous examples are allocated.

	2nd Mortgage Acquisition Debt	2nd Mortgage Equity Debt
Balance 3/94	$180,000	$20,000
1994 allocation	0	10,000
Balance 12/94	$180,000	$10,000
1995 allocation	2,000	10,000
Balance 12/95	$178,000	$0

Line 1

Figure the average balance for 1994 of each mortgage you had on a qualified home on October 13, 1987 (grandfathered debt). Add them together and enter the total on line 1. For mixed-use mortgages, include the average balance for 1994 for the grandfathered debt part of the mixed-use mortgage.

Line 2

Figure the average balance for 1994 of each mortgage you took out on each qualified home after October 13, 1987, to buy, build, or substantially improve that home (home acquisition debt). Add them together and enter the total on line 2. For mixed-use mortgages, include the average balance for 1994 for the home acquisition debt part of the mixed-use mortgage.

However, you must make an additional computation, described next, to figure the average balance if **both** conditions below apply.

1) A home was a qualified home only part of the year.
2) The total of the highest principal balance of all home acquisition debt on the home is more than $1 million ($500,000 if married filing separately).

Additional computation:

1) For each home acquisition debt you took out on this home, figure the average balance over the entire year. Add them together to get the total average balance of these mortgages.
2) For each mortgage in item (1), figure the average balance over the period this home was a qualified home during the year. Add them together to get the total average balance of these mortgages. If this total is $1 million ($500,000) or less, enter the amount in item (1) on Table 1, line 2. If this total is more, then continue.
3) Multiply the average balance you figured in item (1) for each mortgage by a fraction. The numerator of the fraction is $1 million ($500,000) and the denominator is the average balance you figured in item (2) for the mortgage. Add the results and include the total on line 2, Table 1. This is the amount treated as a mortgage taken out after October 13, 1987, to buy, build, or substantially improve this home.

   Do not use this computation when figuring the amount to enter on line 9.

Line 7

The amount on line 7 cannot be more than the ***smaller*** of:

1) $100,000 ($50,000 if married filing separately), or
2) The fair market value of a home (as of the date the last debt was secured by the home) minus the amount on line 5. If the answer is zero or less, enter zero.

If you have two qualified homes, to determine the fair market value in item (2), figure the fair market value of each home as of the date the last debt was secured by the home and then add the two amounts.

See *Home equity debt limit,* earlier, under *Home Equity Debt* for more information about fair market value.

Line 9

Figure the average balance for 1994 of each outstanding home mortgage. Add the average balances together and enter the total on line 9. See *Average Mortgage Balance* earlier. ***Note:*** When figuring the average balance of a mixed-use mortgage, for line 9 determine the average balance of the entire mortgage.

In figuring the average balance to enter on line 9, do not use the *Additional computation* described in the instructions for line 2.

Line 10

If you make payments to a financial institution, or to a person whose business is to make loans, you should get Form 1098, *Mortgage Interest Statement,* or a similar statement from the lender. This form will show the amount of interest to enter on line 10 of the worksheet. Do not include points on this line. Also include on this line any other interest payments made on debts secured by a qualified home for which you did not receive a Form 1098.

Points. Points are charges for borrowing money. They are also called loan origination fees, maximum loan charges, loan discount, or discount points. If any of these charges (points) are only for the use of money, then the points are interest. See *Points* in *Part I,* earlier, to see if your points are deductible.

Note. Points paid on a mortgage that is more than your qualified loan limit must be divided according to how you spent the proceeds. See *Claiming your deductible points,* next.

Claiming your deductible points. If you can stop after filling in line 9 of the worksheet, then you can deduct all the points you are allowed in 1994 on Schedule A (Form 1040), line 10 or 12, whichever applies. If you have to fill in the rest of the worksheet, then you figure your deductible points to enter on Schedule A as follows.

1) Figure your deductible points for 1994.
2) Multiply the amount in item (1) by the decimal amount on line 11 of the worksheet. Enter the result on Schedule A, line 10 or 12, whichever applies. This amount is fully deductible.
3) Subtract the amount in item (2) from the amount in item (1). This amount is not deductible as home mortgage interest. However, if you used any of the loan proceeds in your trade or business, investment, or passive activity, see the instructions for line 13 of the worksheet, next.

Line 13

You ***cannot*** deduct the amount of interest on line 13 of the worksheet as home mortgage interest. If you did not use any of the proceeds of any mortgage included on line 9 of the worksheet in a trade or business, investment, or passive activity, then all the interest on line 13 is personal interest. Personal interest is not deductible.

If you did use all or part of any mortgage proceeds in a trade or business, investment, or passive activity, then you must divide the interest on line 13 of the worksheet according to how you used the proceeds. This is called allocation of interest. See Chapter 8 of Publication 535, *Business Expenses,* for an explanation of the allocation of interest rules.

The following two rules describe how to allocate your interest expense to a trade or business, investment, or passive activity.

1) If you used all of the proceeds for one activity, then all the interest on line 13 is allocated to that activity. In this case, deduct the interest on the form or schedule to which it applies.
2) If you used the proceeds for more than one activity, then the interest on line 13 is allocated among the activities (up to the total amount of interest allocable to each activity).

You figure the amount of interest allocable to any activity by multiplying the amount on line 10 of the worksheet by the following fraction.

$$\frac{\text{part of average balance of mortgage allocated to that activity}}{\text{amount on line 9 of the worksheet}}$$

Table 1. **Worksheet to Figure Your Qualified Loan Limit and Deductible Home Mortgage Interest**

(Keep for your records.) See the Table 1 instructions in this publication.

Part I Qualified Loan Limit			
Note: *If you have a mixed-use mortgage, see* ***Mixed-use mortgages*** *under* ***Table 1 Instructions,*** *before completing lines 1 and 2, below.*			
1 Enter the average balance for 1994 of each mortgage you had on all qualified homes **on October 13, 1987** (grandfathered debt). See line 1 instructions before going to line 2	**1**		
2 Enter the average balance for 1994 of each mortgage you took out on all qualified homes **after** October 13, 1987, for home acquisition debt. See line 2 instructions before going to line 3	**2**		
3 Enter $1,000,000 ($500,000 if married filing separately)	**3**		
4 Enter the **larger of** the amount on line 1 or the amount on line 3	**4**		
5 Add the amounts on lines 1 and 2. Enter the total here	**5**		
6 Enter the **smaller of** the amount on line 4 or the amount on line 5	**6**		
7 Enter $100,000 ($50,000 if married filing separately). See line 7 instructions for fair market value limit	**7**		
8 Add the amounts on lines 6 and 7. Enter the total. This is your qualified loan limit	**8**		

Part II Deductible Home Mortgage Interest			
9 Enter the total of the average balances for 1994 of all mortgages on **all** qualified homes. (In figuring the amount to enter here, do not use the *Additional computation* in the line 2 instructions.)	**9**		
• If line 8 is less than line 9, GO ON to line 10. • If line 8 is equal to or more than line 9, STOP HERE. All of your interest on all the mortgages included on line 9 is deductible as home mortgage interest on Schedule A (Form 1040), line 10 or 11, whichever applies. See Table 1 instructions for line 10 to find out how to deduct points. **10** Enter the total amount of interest that accrued while the debt was secured by your qualified home and that you paid in 1994. Do not include points on this line. See Table 1 instructions for line 10 to find out how to deduct points	**10**		
11 Divide the amount on line 8 by the amount on line 9. Enter the result as a decimal amount (rounded to three places)	**11**	**x.**	
12 Multiply the amount on line 10 by the decimal amount on line 11. Enter the result. This is your **deductible home mortgage interest.** Enter this amount on Schedule A (Form 1040), line 10 or 11, whichever applies	**12**		
13 Subtract the amount on line 12 from the amount on line 10. Enter the result. This is **not home mortgage interest.** See the instructions for line 13 to determine whether you can deduct this interest on your tax return and, if so, where	**13**		

The amount allocable to any one activity cannot be more than the amount on line 13 minus the total amount of interest allocable to the other activities.

Example. Don had two mortgages (A and B) on his main home during all of 1994. Mortgage A had an average balance of $90,000 for 1994 and mortgage B had an average balance of $110,000. Don files as head of household.

Under the allocation of interest rules, Don determines that the proceeds of mortgage A are allocable to personal expenses for all of 1994. The proceeds of mortgage B are allocable to his business for all of 1994. Don paid $14,000 of interest on mortgage A and $16,000 of interest on mortgage B. He figures the amount of home mortgage interest he can deduct by using Table 1. Don determines that $15,000 of the interest can be deducted as home mortgage interest.

Don's interest allocable to the trade or business is equal to the ***smaller*** of:

1) The amount on line 13 of the worksheet ($15,000), or
2) The total interest paid ($30,000) multiplied by the following fraction

$$\frac{\text{\$110,000 (the average balance of the mortgage allocated to the trade or business)}}{\text{\$200,000 (the total average balance of all mortgages— line 9 of the worksheet}} = \$16,500$$

Because $15,000 is the smaller of items (1) and (2), that is the amount of interest Don can allocate to the trade or business. He deducts this amount on his Schedule C (Form 1040) that he files for his trade or business.

Special Rule for Tenant-Stockholders in Cooperative Housing Corporations

A qualified home includes stock in a cooperative housing corporation owned by a tenant-stockholder. This applies only if the tenant-stockholder is entitled to live in the house or apartment because of owning stock in the cooperative.

Stock used to secure debt. In some cases, you cannot use your cooperative housing stock to secure the debt because of either:

1) Restrictions under local or state law, or
2) Restrictions in the cooperative agreement (other than restrictions in which the main purpose is to permit the tenant-stockholder to treat unsecured debt as secured debt).

However, you can treat the debt as secured by the stock to the extent that the proceeds are used to buy the stock under the allocation of interest rules. See Chapter 8 of Publication 535 for details on these rules.

Figuring deductible home mortgage interest. Generally, any interest of the cooperative that is allowed as a deduction to a tenant-stockholder under the Internal Revenue Code is treated as interest paid or accrued by the tenant-stockholder.

If any amount is treated as interest paid or accrued by you, the tenant-stockholder, treat your share of the cooperative's debt as debt incurred by you. The cooperative should determine your share of its grandfathered debt, its home acquisition debt, and its home equity debt. Your share of each of these types of debt is equal to the average balance of each debt multiplied by the following fraction.

$$\frac{\text{your share of stock in the cooperative}}{\text{the total stock of the cooperative}}$$

In determining the cooperative's home acquisition debt, a debt taken out to buy, build, or improve any nonresidential part of the property does not qualify. Also, in determining the fair market value of the residential property, the fair market value of any nonresidential part does not qualify.

After your share of the average balance of each type of debt is determined, include the amounts with any other mortgages on your home.

Figure your home mortgage interest by multiplying the cooperative's deductible interest by the same fraction. The cooperative should provide you a Form 1098 showing your share of the interest. Use the rules and *Table 1* in this publication to determine your deductible mortgage interest.

Example. Jeanne owns 20 shares in a cooperative, in which the total shares are 2,000. The cooperative took out a debt on January 1, 1994, with a principal balance of $2 million. The cooperative made no principal payments in 1994, but it did pay $200,000 interest on the debt.

By the end of 1994, the cooperative used the debt proceeds in the following manner.

1) $500,000 to install a swimming pool for the use of all the residents.
2) $1.4 million to make improvements to commercial space rented to tenants.
3) $100,000 for maintenance costs.

The amount of the cooperative's home acquisition debt is $500,000. Jeanne's share is $5,000 ($500,000 × (20/2,000)).

The amount of the cooperative's home equity debt is $1.5 million ($1.4 million + $100,000). Jeanne's share is $15,000 ($1.5 million × (20/2,000)).

Jeanne is treated as having paid $2,000 of interest during 1994 on the cooperative's debt ($200,000 × (20/2,000)).

Jeanne also took out a home acquisition debt to buy her shares in the cooperative. Her average balance for 1994 was $40,000.

Jeanne's home acquisition debt ($5,000 + $40,000 = $45,000) totaled less than $1 million (the dollar limit that applies to these mortgages) and her home equity debt ($15,000) is less than $100,000 (the dollar limit that applies to these mortgages). All of her home mortgage interest is deductible.

Publications List

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Table 2. **Where to Deduct Your Interest**

Type of interest	Where to deduct	Where to find information
Deductible home mortgage interest and points reported on Form 1098	Schedule A (Form 1040), line 10	Publication 936
Deductible home mortgage interest *not* reported on Form 1098	Schedule A (Form 1040), line 11	Publication 936
Points *not* reported on Form 1098	Schedule A (Form 1040), line 12	Publication 936
Investment interest (other than incurred to produce rents or royalties)	Schedule A (Form 1040), line 13	Publication 550
Business interest (non-farm)	Schedule C (Form 1040)	Publications 334 and 535
Farm business interest	Schedule F (Form 1040)	Publications 225 and 535
Interest incurred to produce rents or royalties	Schedule E (Form 1040)	Publications 527 and 535
Personal interest	Not deductible	

List of Tax Publications for Individuals

General Guides

1 ...... Your Rights as a Taxpayer
17 ..... Your Federal Income Tax
225 .. Farmer's Tax Guide
334 .. Tax Guide for Small Business
509 .. Tax Calendars for 1995
553 .. Highlights of 1994 Tax Changes
910 .. Guide to Free Tax Services (Includes a list of publications)

Specialized Publications

3 ...... Tax Information for Military Personnel (Including Reservists Called to Active Duty)
54 ..... Tax Guide for U.S. Citizens and Resident Aliens Abroad
378 .. Fuel Tax Credits and Refunds
448 .. Federal Estate and Gift Taxes
463 .. Travel, Entertainment, and Gift Expenses
501 .. Exemptions, Standard Deduction, and Filing Information
502 .. Medical and Dental Expenses
503 .. Child and Dependent Care Expenses
504 .. Divorced or Separated Individuals
505 .. Tax Withholding and Estimated Tax
508 .. Educational Expenses
513 .. Tax Information for Visitors to the United States
514 .. Foreign Tax Credit for Individuals
516 .. Tax Information for U.S. Government Civilian Employees Stationed Abroad
517 .. Social Security and Other Information for Members of the Clergy and Religious Workers
519 .. U.S. Tax Guide for Aliens
520 .. Scholarships and Fellowships
521 .. Moving Expenses
523 .. Selling Your Home
524 .. Credit for the Elderly or the Disabled
525 .. Taxable and Nontaxable Income
526 .. Charitable Contributions
527 .. Residential Rental Property
529 .. Miscellaneous Deductions
530 .. Tax Information for First-Time Homeowners
531 .. Reporting Tip Income
533 .. Self-Employment Tax
534 .. Depreciation
537 .. Installment Sales
541 .. Tax Information on Partnerships
544 .. Sales and Other Dispositions of Assets
547 .. Nonbusiness Disasters, Casualties, and Thefts
550 .. Investment Income and Expenses
551 .. Basis of Assets
552 .. Recordkeeping for Individuals
554 .. Tax Information for Older Americans
555 .. Federal Tax Information on Community Property
556 .. Examination of Returns, Appeal Rights, and Claims for Refund
559 .. Survivors, Executors, and Administrators
560 .. Retirement Plans for the Self-Employed
561 .. Determining the Value of Donated Property
564 .. Mutual Fund Distributions
570 .. Tax Guide for Individuals with Income from U.S. Possessions
571 .. Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations
575 .. Pension and Annuity Income (Including Simplified General Rule)
584 .. Nonbusiness Disaster, Casualty, and Theft Loss Workbook
587 .. Business Use of Your Home
590 .. Individual Retirement Arrangements (IRAs)
593 .. Tax Highlights for U.S. Citizens and Residents Going Abroad
594 .. Understanding The Collection Process
596 .. Earned Income Credit
597 .. Information on the United States-Canada Income Tax Treaty
721 .. Tax Guide to U.S. Civil Service Retirement Benefits
901 .. U.S. Tax Treaties
907 .. Tax Highlights for Persons with Disabilities
908 .. Tax Information on Bankruptcy
911 .. Tax Information for Direct Sellers
915 .. Social Security Benefits and Equivalent Railroad Retirement Benefits
917 .. Business Use of a Car
919 .. Is My Withholding Correct for 1995?
925 .. Passive Activity and At-Risk Rules
926 .. Employment Taxes for Household Employers
929 .. Tax Rules for Children and Dependents
936 .. Home Mortgage Interest Deduction
938 .. Real Estate Mortgage Investment Conduits (REMICs) Reporting Information
945 .. Tax Information for Those Affected by Operation Desert Storm
946 .. How To Begin Depreciating Your Property
947 .. Practice Before the IRS and Power of Attorney
950 .. Introduction to Estate and Gift Taxes
1244 .. Employee's Daily Record of Tips and Report to Employers
1542 .. Per Diem Rates
1544 .. Reporting Cash Payments of Over $10,000
1546 .. How to use the Problem Resolution Program of the IRS

Spanish Language Publications

1SP .. Derechos del Contribuyente
556SP .. Revisión de las Declaraciones de Impuesto, Derecho de Apelación y Reclamaciones de Reembolsos
579SP .. Cómo Preparar la Declaración de Impuesto Federal
594SP .. Comprendiendo el Proceso de Cobro
596SP .. Crédito por Ingreso del Trabajo
850 .. English–Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service

Tax forms, publications and instructions listed on the order blank

You can get the following forms, schedules, and instructions at participating banks, post offices, or libraries.

Form 1040
Instructions for Form 1040 & Schedules
Schedule A for itemized deductions
Schedule B for interest and dividend income if over $400; and for answering the foreign accounts or foreign trusts questions
Schedule EIC for the earned income credit
Form 1040A
Instructions for Form 1040A & Schedules
Schedule 1 for Form 1040A filers to report interest and dividend income
Schedule 2 for Form 1040A filers to report child and dependent care expenses
Form 1040EZ
Instructions for Form 1040EZ

You can photocopy the items listed below (as well as those listed above) at participating libraries or order them from the IRS.

Schedule 3, Credit for the Elderly or the Disabled for Form 1040A Filers
Schedule C, Profit or Loss From Business
Schedule C-EZ, Net Profit From Business
Schedule D, Capital Gains and Losses
Schedule E, Supplemental Income and Loss
Schedule F, Profit or Loss From Farming
Schedule R, Credit for the Elderly or the Disabled
Schedule SE, Self-Employment Tax
Form 1040-ES, Estimated Tax for Individuals
Form 1040X, Amended U.S. Individual Income Tax Return
Form 2106, Employee Business Expenses
Form 2106-EZ, Unreimbursed Employee Business Expenses
Form 2119, Sale of Your Home
Form 2210, Underpayment of Estimated Tax by Individuals and Fiduciaries
Form 2441, Child and Dependent Care Expenses
Form 3903, Moving Expenses
Form 4562, Depreciation and Amortization
Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
Form 5329, Return for Additional Taxes Attributable to Qualified Retirement Plans, Annuities, and Modified Endowment Contracts
Form 8283, Noncash Charitable Contributions
Form 8582, Passive Activity Loss Limitations
Form 8606, Nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions
Form 8822, Change of Address
Form 8829, Expenses for Business Use of Your Home

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Schedules A&B (1040)	Schedule SE (1040)	1040-ES (1995) & Instructions	4562 & instructions	Pub. 1	Pub. 521	Pub. 590	
Schedule C (1040)	1040A	1040X & Instructions	4868 & Instructions	Pub. 17	Pub. 523	Pub. 596	
Schedule C-EZ (1040)	Instructions for 1040A & Schedules	2106 & Instructions	5329 & Instructions	Pub. 334	Pub. 525	Pub. 910	
Schedule D (1040)	Schedule 1 (1040A)	2106-EZ & Instructions	8283 & Instructions	Pub. 463	Pub. 527	Pub. 917	
Schedule E (1040)	Schedule 2 (1040A)	2119 & Instructions	8582 & Instructions	Pub. 501	Pub. 529	Pub. 929	
Schedule EIC (1040A or 1040)	Schedule 3 (1040A) & Instructions	2210 & Instructions	8606 & Instructions	Pub. 502	Pub. 550	Pub. 936	

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