Election to Treat Home Mortgage Interest as Business Interest

10-T election. A taxpayer can elect to treat debt secured by a home as not secured by a home. [Reg. §1.163-10T(o)(5)]

A taxpayer may want to treat a debt as not secured by his or her home if the interest on that debt is fully deductible whether or not it qualifies as home mortgage interest. This may allow a greater deduction for interest on other debts that are only deductible as home mortgage interest.

- The election applies for the initial tax year and all subsequent tax years and may not be revoked without IRS consent.
- The election must apply to the entire indebtedness.
- The election is made by reporting the interest on the return as business interest or other deductible interest rather than qualified residence interest.
- Late elections have been permitted under Regulation section 301.9100.
- If the 10-T election is not made, the proceeds of the home equity loan are first considered to be equity borrowing and only the amount over the $100,000 debt equity limit can be traced and treated as business interest. (CCA 201201017)

Example: Jan took out a home equity loan to buy equipment for her business. She does not itemize her deductions on Schedule A. If Jan elects to treat the entire debt as not secured by her home and can trace the loan proceeds to her business, she can deduct the interest paid as a business expense.

Author’s Comment: The IRS gives no specific format for the 10-T election. It is recommended that the election be made in writing, attached to the return for the initial election year, and should specify the amount of home equity debt to be treated as trade or business debt, as well as the amount of interest and the location on the return where it is claimed. Taxpayers should keep careful records to prove how the loan proceeds have been used.

Legal Liability to Make Payments

A taxpayer must be legally liable for the loan to deduct interest on a home mortgage. Payments made on a loan in which the taxpayer is not directly liable are deductible only if the taxpayer is the legal or equitable owner of the real estate. [Reg. §1.163-1(f)]

Example: Murphy lives in his mother’s house and is not listed on the house title or mortgage. Murphy makes her payments because he is supporting her as his dependent. Murphy cannot deduct the interest as home mortgage interest because he is not liable for the debt and not a co-owner of the house.

Court Case: A taxpayer helped make the down payment on a house, but the mortgage and legal title were in his parents’ names. The taxpayer resided in the home and made mortgage payments, and his parents deeded a portion of the ownership to him at the end of the year to reflect the payments he made. The Tax Court allowed the taxpayer to deduct the mortgage interest, subject to the acquisition indebtedness limitations, because he was obligated to make the mortgage payments per his agreement with his parents. (Edosada, T.C. Summary 2012-17)

Form 1098, Mortgage Interest Statement

Was Form 1098 issued in the taxpayer’s Social Security number?

Yes

- Report deductible mortgage interest on Schedule A, line 11.
- Include the name, identifying number, and address of the interest recipient in the space provided next to line 11.
- If another taxpayer (other than a spouse filing jointly) received Form 1098 for mortgage interest paid by the taxpayer, and for which the taxpayer is liable, attach a statement showing the name and address of that person.

Prepaid interest on Form 1098. If the taxpayer prepaid interest in 2015 that accrues in full by January 15, 2016, this prepaid interest may be included in box 1, Form 1098. However, the prepaid amount for January 2016 is not deductible in 2015. This rule does not apply if the prepaid interest is deductible as points. See Points and Loan Origination Fees, below.

Form 1098-MA, Mortgage Assistance Payments

Form 1098-MA is used to report mortgage assistance payments made from the federal Emergency Homeowners’ Loan Program (EHLP), the HFA Hardest Hit Fund, or similar approved state programs.

- Assistance received under these programs is tax free.
- Form 1098-MA reports the amount of assistance received, not the amount of interest paid. Interest is still reported on Form 1098.

Safe harbor rule (Notice 2013-7). For tax years 2010 through 2015, a homeowner may deduct the lesser of:

- The sum of all mortgage payments that the homeowner actually makes to the mortgage servicer, HUD, or the state HFA, or
- The sum of amounts shown on Form 1098 for mortgage interest received, real property taxes, and mortgage insurance premiums. See Mortgage Insurance Premiums, page 4-12.

Mortgage assistance payments under section 235 of the National Housing Act. If the taxpayer qualifies for mortgage assistance payments under section 235 of the National Housing Act, mortgage interest may be paid for the taxpayer. The taxpayer cannot deduct the interest paid for him or her.

Reverse Mortgages

A reverse mortgage is sometimes called a lifetime mortgage. A home equity conversion mortgage (HECM) is an FHA reverse mortgage.

- While still occupying and retaining title to the home, the homeowner receives money from a lender in the form of a lump sum, monthly advance, line of credit, or any combination of the three.
- Amounts received under a reverse mortgage are nontaxable loan advances on a home equity loan. Depending on the plan, the reverse mortgage loan becomes due when the loan period ends, or when the owner moves, reaches a specified age, sells the home, or dies.
- Mortgage interest accrues on the reverse mortgage proceeds, but the interest is not deductible until actually paid. Any interest deduction is subject to the usual home equity debt limits. See Deductible Home Mortgage Interest, page 4-10.

Example: Louise owns her home, worth $175,000, outright. She takes a reverse mortgage and receives a monthly payment of $500. The annual income of $6,000 is not taxable. The interest accumulated on the reverse mortgage is not deductible until Louise sells her home or she dies. Because the reverse mortgage is considered a home equity debt, the eventual deduction will be subject to the limitations of home equity debt.

Points and Loan Origination Fees

Terms such as “points,” loan origination fees, maximum loan charges, loan discount, loan buy down, or discount points refer to certain charges paid to obtain a home mortgage. Points are generally paid directly to the lender at closing in exchange for a lower interest rate. Each “point” charged to obtain a loan is 1% of...
the loan amount. For example, 2.5 points charged on a $100,000 loan equals $2,500 ($100,000 × 2.5%).

**General rule.** Generally, points cannot be deducted fully in the year paid. Because points are prepaid interest, they are deducted ratably over the life of the loan. For exceptions to the general rule, see [Deduction allowed in year paid](#), below. Report deductible points on Schedule A:
- Line 10, if paid at closing to purchase a home and reported to the taxpayer on Form 1098, [Mortgage Interest Statement](#).
- Line 12, if not reported to the taxpayer on Form 1098.

**Other costs.** Fees, such as appraisal fees, are added to basis if the fee is related to buying the property but not added to basis if the fee is to secure a loan.

**Deduction allowed in year paid.** Points are fully deductible in the year paid if all the following are true.
1. The loan is secured by the taxpayer's main home.
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 that area.
4. The taxpayer uses the cash method of accounting.
5. 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.
6. The funds the taxpayer paid at closing, plus any seller paid points, were at least as much as the points charged. The funds paid do not have to have been applied to the points. The funds paid can include a down payment, an escrow deposit, earnest money, etc. The funds cannot have been borrowed from the lender or mortgage broker.
7. The loan is used to buy or build the taxpayer’s main home (not a second home).
8. The points were computed as a percentage of the principal amount of the mortgage.
9. The points are clearly shown on the settlement statement as points charged for the mortgage.

If all the above are met, the taxpayer can choose to either fully deduct the points in the year paid or amortize them over the life of the mortgage.

**Planning Tip:** First-time homebuyers who purchase a residence late in the year often find they do not have enough mortgage interest or property taxes accumulated to benefit from itemizing deductions. In this case, amortizing the points provides tax benefits by extending the deduction into future years. Although the yearly deduction may be small when amortized over 15 or 30 years, a large deduction can be waiting for the taxpayer if the mortgage is paid off early. See [Mortgage paid off early](#), next column.

**Loans to substantially improve a main home.** If tests 1 through 6, above, are met, the taxpayer can fully deduct points paid on both home improvement or equity loans, and on “cash-out” refinancing loans used to substantially improve the taxpayer’s main home.

**Mixed use proceeds.** If proceeds from a loan are used to both substantially improve the taxpayer’s main home and for other purposes, the points are apportioned between the amounts used for each purpose and deducted accordingly.

**Example:** Pete took out a 15-year home equity loan of $80,000 on July 1, 2015, and paid $800 in points to secure the loan. He used $600 of the proceeds to put an addition on his primary residence and used the remaining $20,000 to take a vacation. Pete deducts the $600 in points in 2015 and amortizes the remaining $200 over the 15-year life of the loan.

**Deducting points ratably over life of loan.** If the tests under [Deduction allowed in year paid](#), above, are not met, the loan is not a home improvement loan, or the taxpayer chooses not to deduct the points in full in the year paid, the points are deducted ratably over the life of the loan if all of the following tests are met.
- The taxpayer uses the cash method of accounting.
- The loan is secured by a home (does not need to be the taxpayer’s main home).
- The loan period is not more than 30 years.
- If the loan period is more than 10 years, the terms of the loan are the same as other loans offered in the area for the same or longer period.
- Either the loan amount is $250,000 or less, or the number of points is not more than four if the loan period is 15 years or less, or six if the loan period is more than 15 years.

If the taxpayer does not meet the requirements above, the points reduce the issue price of the loan. This reduction results in original issue discount. See IRS Pub. 535 for original issue discount rules.

**Seller-paid points.** Points are treated as having been paid by the buyer.

<table>
<thead>
<tr>
<th>Seller</th>
<th>Buyer</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Cannot deduct seller-paid points.</td>
<td>• Deducts eligible seller-paid points as if buyer had paid them, either in full or ratably over mortgage life, as applicable.</td>
</tr>
<tr>
<td>• Reduces amount realized on home sale by amount of points.</td>
<td>• Reduces the home’s basis by the amount of points deducted.</td>
</tr>
</tbody>
</table>

**Mortgage paid off early.** Any remaining balance of points being deducted over the life of the mortgage is deducted in full when the mortgage ends. This can happen when the mortgage is paid off early, paid off as part of the house sale, or refinanced with a new lender.

**Second home, business property, and investment property.** Points paid to obtain financing to purchase property that is not the taxpayer’s main home must be amortized over the life of the loan.

**Limits on deducting points.** Points are not deductible to the extent the mortgage debt exceeds the limits discussed under [Home Mortgage Interest](#), page 4-10.

### Mortgage Insurance Premiums

**Note:** The deduction for mortgage insurance premiums expired after December 31, 2014, and had not been extended as of the date of printing. See [What’s New, Tab 1](#), for late-breaking legislation.

Under this provision, premiums paid for acquisition indebtedness for insurance contracts issued after December 31, 2006 on a first or second home are treated as deductible mortgage interest, subject to phaseout rules.
- Decrease of 10% for each $1,000 (or portion thereof) by which the taxpayer’s AGI exceeds $100,000 ($500 and $50,000 for MFS).
- No deduction when AGI exceeds $109,000 ($54,500 for MFS).

Qualified mortgage insurance providers include the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration, and private mortgage insurance.

**Prepaid mortgage insurance premiums.** If a taxpayer prepays a portion or all of the mortgage insurance premiums, the prepaid amount must be amortized over the shorter of:
- The stated term of the mortgage, or
- 84 months (7 years) beginning with the month in which the mortgage insurance was obtained. (Notice 2008-15)

These allocation rules do not apply to mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Authority.