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TAX ASPECTS OF REFINANCING A HOME MORTGAGE

With home mortgage rates at the lowest level in years, you may have recently refinanced or may be considering refinancing your adjustable-rate or higher-interest fixed-rate mortgage to "lock in" what looks like a real bargain. Although taxes take a back seat to the basic issue of whether refinancing saves enough money to be worthwhile, you should be aware of the basic tax rules which come into play. In some cases, you may be pleasantly surprised at the tax deductions you will be able to claim as a result of refinancing. However, in some cases, you may wind up with fewer deductions than you had expected.

INTEREST ON NEW LOAN

The most widely applicable rules are as follows:

1. The interest you pay on the new loan will be completely deductible if (a) the new loan amount does not exceed the balance remaining on your old mortgage; (b) when you got the mortgage you are replacing, you used the loan proceeds to buy or substantially improve your home; and (c) the new loan balance doesn't exceed $1 million.

2. Interest you pay on borrowed funds in excess of the amount necessary to retire the old mortgage also will be completely deductible to the extent the new money is used to substantially improve your home (for example, adding a bedroom).

3. To the extent they are not used for substantial improvements, borrowed funds in excess of the amount necessary to retire the old mortgage will be deductible as "home-equity debt." Generally, the interest paid on up to $100,000 of that debt is deductible as home mortgage interest regardless of how the proceeds are used (but you can not deduct the interest if you use the proceeds to buy tax-exempt bonds).

What these rules boil down to is: the interest you pay on the new loan usually will be deductible if (1) you are refinancing your old mortgage dollar-for-dollar; (2) your new loan amount exceeds the old mortgage's remaining balance and you use the new money for substantial improvements to your home; or, (3) the new loan money is not used for home improvements, but does not exceed $100,000.

POINTS ON THE NEW LOAN

Points paid in connection with buying or substantially improving your main home are currently deductible. However, if you must pay points on a refinance loan, this charge will be currently deductible only if you pay the charge out of your own cash at closing (that is, the charge is not withheld from the mortgage loan); and only to the extent the new loan proceeds are used to substantially improve your home. So if you refinance

your existing home mortgage and use none of the new loan for substantial improvements to your home, any points you pay on the transaction will not be currently deductible. Instead, you will have to amortize the points over the life of the new mortgage.

DEDUCTIONS FROM BAILING OUT OF THE OLD MORTGAGE

You may have to pay the bank a repayment penalty to pay off your existing mortgage. If that is the case, the penalty will be fully deductible if the interest you paid on the retired mortgage was deductible as home mortgage interest.

POINTS BALANCE ON THE OLD MORTGAGE

You may have had to pay points when you got the mortgage you now want to refinance. If you were required to amortize the points over the life of your existing mortgage, the part of the points you have not yet deducted may be deducted currently as interest (again, assuming the interest you paid on your existing mortgage was deductible as home mortgage interest).

For example, suppose you refinanced your home mortgage several years ago and used the proceeds to pay off in full your original home mortgage. Your refinancing mortgage (loan #2) was a 30-year fixed-rate loan for $100,000. You paid three points ($3,000) on the refinancing. Because all of the loan proceeds were used to pay off the original mortgage and none were used to buy or substantially improve your home, all of the points on the refinancing loan had to be amortized over the loan term. This year, you refinance again with a lower-interest mortgage (loan #3) when there is a remaining (not-yet-deducted) points balance of $2,400 on loan #2. You can deduct the $2,400 as home mortgage interest on your 1998 return.

As you can see, refinancing a home mortgage is anything but simple. There may be additional complications if there are several mortgages on your home or if you own a vacation home as well as a main home.