IRS Okays Home Equity Deductions

As previously reported in the April 2018 edition of the *Sapient CPA Client Bulletin*, the Tax Cuts and Jobs Act of 2017 affected the tax deduction for interest paid on home equity debt as of 2018. Under prior law, you could deduct interest on up to $100,000 of home equity debt, no matter how you used the money. The old rule is scheduled to return in 2026.

The bad news is that you now cannot deduct interest on home equity loans or home equity lines of credit if you use the money for college bills, medical expenses, paying down credit card debt, and so on. The good news is that the IRS has announced "Interest on Home Equity Loans Often Still Deductible Under New Law." The details are in IR 2018-32, a news release from the IRS.

The Book, Not the Cover

According to the IRS, even if a loan is labeled "home equity," the interest may be deductible on your tax return. The key is how the borrowed money is used. In addition, the $100,000 ceiling doesn't apply.

For home loan interest to be tax deductible, the taxpayer that secures the loan must use the money to buy, build, or substantially improve his or her home. Beginning in 2018, taxpayers may only deduct interest on $750,000 of such "qualified residence loans," or $375,000 for a married taxpayer filing separately.

Those numbers apply to the total of a taxpayer's home loans, but older loans up to $1 million and $500,000, respectively, may have fully deductible interest. As before, home loan interest on debt that exceeds the cost of the home won't be eligible for an interest deduction, among other requirements.

Fine Points

For home loans obtained in 2018 and future years, some tax rules are clear, but some are more complex.

Example 1: Eve Harper gets a $500,000 loan from Main Street Bank to buy a home in July 2018. In November 2018, Eve gets a $50,000 "home equity" loan from Broad Street Bank, which she uses to buy a car. The interest on the second loan is not tax deductible.

Example 2: Same as example 1, except that Eve uses the Broad Street Bank loan to install central air conditioning, add a powder room, and upgrade plumbing throughout her new home. The interest on both of these loans will be deductible.

The tax treatment of these examples may seem straightforward, but that's not always true.

Example 3: Same as example 1, except that the Broad Street Bank loan is used to make a down payment on a mountain cabin, where Eve plans to go for vacations. Interest on this $50,000 loan is deductible because the total of both loans does not exceed $750,000, and the $50,000 loan is secured by the cabin. Indeed, Eve could get a loan up to $250,000 (for a $750,000 total of home loans) to buy the cabin and still deduct the interest, as long as this loan is secured by the cabin.

Example 4: Same as example 3, except that the Broad Street Bank loan is secured by Eve's main home, not by the cabin she's buying. Now, the Broad Street Bank loan would be considered home equity debt no matter how much was borrowed, and no interest on that loan could be deducted.

Over the Limit

What would happen if Eve gets a $500,000 loan in June to buy her main house and another $500,000 loan in November to buy a vacation home? She would be over the $750,000 debt limit for deducting interest on 2018 home loans, so only a percentage of the interest paid would be tax deductible.

The bottom line is that if you intend to use a home equity loan to buy, build, or substantially improve a home, you should be careful about how the debt is secured. Be prepared to show that the money really was used for qualified purposes.

Moreover, qualified home loans obtained on or before December 15, 2017, are grandfathered, with tax deductions allowed for interest up to $1 million or $500,000, as explained. Some questions remain, though, about how refinancing those grandfathered loans will affect the tax treatment. If you are considering refinancing a home loan that's now grandfathered, our office can provide the latest guidance on how your taxes might be affected.

Trusted Advice

Secured Debt

- Home loan interest is deductible, up to the applicable limit, only if the obligation is a secured debt.
- You must sign an instrument, such as a mortgage, deed of trust, or land contract, that makes your ownership interest in a qualified home security for payment of the debt.

- A qualified home includes a house, condominium, mobile home, boat, or house trailer with sleeping, cooking, and toilet facilities that is your main home or second home.
- In case of default, the home used as security can satisfy the debt.
- This arrangement must be recorded or otherwise officially noted under the relevant state or local law.