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TAX UPDATE

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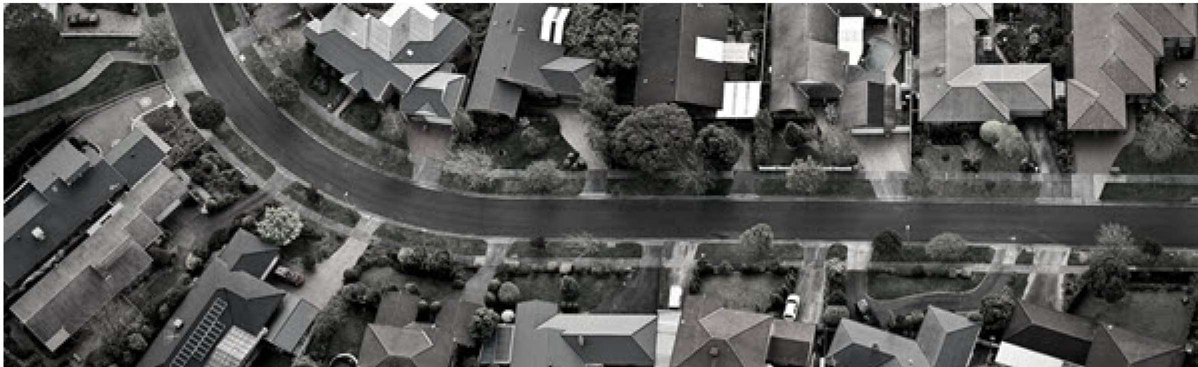
IRS Clarifies New Tax Law regarding Deductions for Homeowners

Passage of the Tax Cuts and Jobs Act (TCJA) in December 2017 has led to confusion over some of the changes to longstanding deductions, including the deduction for interest on home equity loans. In response, the IRS has issued a statement clarifying that the interest on home equity loans, home equity lines of credit and second mortgages will, in many cases, remain deductible under the TCJA — regardless of how the loan is labeled.



Previous Provisions

Under prior tax law, taxpayers could deduct "qualified residence interest" on a loan of up to $1 million secured by a qualified residence, plus interest on a home equity loan (other than debt used to acquire a home) up to $100,000. The home equity debt couldn't exceed the fair market value (FMV) of the home reduced by the debt used to acquire the home.

For tax purposes, a qualified residence is the taxpayer's principal residence and a second residence, which can be a house, condominium, cooperative, mobile home, house trailer or boat. The principal residence is where the taxpayer resides most of the time; the second residence is any other residence the taxpayer owns and treats as a second home. Taxpayers aren't required to use the second home during the year to claim the deduction. If the second home is rented to others, though, the taxpayer also must use it as a home during the year for the greater of 14 days or 10% of the number of days it's rented.

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In the past, interest on qualifying home equity debt was deductible regardless of how the loan proceeds were used. A taxpayer could, for example, use the proceeds to pay for medical bills, tuition, vacations, vehicles and other personal expenses and still claim the itemized interest deduction.

The TCJA Rules

The TCJA limits the amount of the mortgage interest deduction for taxpayers who itemize through 2025. Beginning with loans taken out in 2018, a taxpayer can deduct interest only on mortgage debt of $750,000 (down from $1 million). The congressional conference report on the law stated that it also suspends the deduction for interest on home equity debt, regardless of when the debt was incurred. And the actual bill includes the section caption “DISALLOWANCE OF HOME EQUITY INDEBTEDNESS INTEREST.” As a result, many people believed the TCJA eliminates the home equity loan interest deduction.

On February 21, 2018, the IRS issued a release (IR 2018-32) explaining that the law suspends the deduction only for interest on home equity loans and lines of credit that aren’t used to buy, build or substantially improve the taxpayer’s home that secures the loan. In other words, the interest isn’t deductible if the loan proceeds are used for certain personal expenses, but it is if the proceeds go toward, for example, a new roof on the home that secures the loan. The IRS further stated that the deduction limits apply to the combined amount of mortgage and home equity acquisition loans — home equity debt is no longer capped at $100,000 for purposes of the deduction.

Some examples from the IRS help show how the TCJA rules work:

> ***Example 1***
> A taxpayer took out a $500,000 mortgage to buy a principal residence with an FMV of $800,000 in January 2018. The loan is secured by the residence. In February, he takes out a $250,000 home equity loan to pay for an addition to the home. Both loans are secured by the principal residence, and the total doesn’t exceed the value of the home.
>
> The taxpayer can deduct all of the interest on both loans because the total loan amount doesn’t exceed $750,000. If he used the home equity loan proceeds to pay off student loans and credit card bills, though, the interest on that loan wouldn’t be deductible.
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> ***Example 2***
> The taxpayer from the previous example takes out the same mortgage in January. In February, he also takes out a $250,000 loan to buy a vacation home, securing the loan with that home. Because the total amount of both mortgages doesn’t exceed $750,000, he can deduct all of the interest paid on both mortgages. But, if he took out a $250,000

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home equity loan on the principal home to buy the second home, the interest on the home equity loan wouldn't be deductible.

Example 3
In January 2018, a taxpayer took out a $500,000 mortgage to buy a principal home, secured by the home. In February, she takes out a $500,000 loan to buy a vacation home, securing the loan with that home. Because the total amount of both mortgages exceeds $750,000, she can deduct only a percentage of the total interest she pays on them.

Stay Tuned

The new IRS announcement highlights the fact that the nuances of the TCJA will take some time to shake out completely. We'll keep you updated on the most significant new rules and guidance as they emerge.

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