IRS Issues Additional Guidance Related to Deductibility of Interest on Home Equity Loans Under the New Law

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The Tax Cut and Jobs Act of 2017 (the Act) further limited the interest deduction on home mortgage interest and disallowed the interest deduction for home equity loans for tax years beginning after December 31, 2017 and before January 1, 2026. On February 21, 2018, the Internal Revenue Service (IRS) issued guidance through IR-2018-32, advising taxpayers that, in many cases, interest paid on home equity loans can still be deductible.

The Act imposes a lower dollar limitation on mortgages qualifying for the home mortgage interest deduction. Beginning in 2018, taxpayers may only deduct interest on $750,000 ($375,000 for married taxpayers filing separately) of qualified residence mortgages. For qualified residence mortgages incurred before December 15, 2017, the limit remains at $1,000,000 ($500,000 for married taxpayers filing separately). The limits apply to the combined amount used to buy, build or substantially improve the taxpayer's primary residence and one second home.

Under the new law, for example, interest on a home equity loan used to build an addition to an existing home is typically deductible, while interest on the same loan used to pay personal living expenses, such as credit card debts, is not. As under prior law, the loan must be secured by the taxpayer's main home or second home (known as a qualified residence), not to exceed the cost of the home, and must meet other requirements.

Even though the Act suspends the deduction for home equity loans, IR-2018-32 explains that interest on home equity loans is still deductible if the loans are qualified residence mortgage loans. Home equity loans are qualified residence mortgage loans if the home equity loan proceeds were used to buy, build or substantially improve the taxpayer's primary or secondary home, the loan is secured by the taxpayer's primary residence or second home, the loan does not exceed the cost of the qualified residence (when combined with other qualifying home mortgages) and the loan meets the other requirements to qualify as a home mortgage. Interest on qualifying home equity loans will be deductible regardless of how the loan is labelled, such as a home equity loan, home equity line of credit or second mortgage. For further clarification, the home equity loan must be secured by the property for which the proceeds were used to buy, build or substantially improve.

IRS IR-2018-32 provides three examples to illustrate these points.

Example 1

In January 2018, a taxpayer takes out a $500,000 mortgage to purchase a main home with a fair market value of $800,000. In February 2018, the taxpayer takes out a $250,000 home equity loan to put an addition on the main home. Both loans are secured by the main home and the total does not exceed the cost of the home. Because the total amount of both loans does not exceed $750,000, all of the interest paid on the loans is deductible. However, if the taxpayer used the home equity loan proceeds for personal expenses, such as paying off student loans or credit cards, then the interest on the home equity loan would not be deductible.

Example 2

In January 2018, a taxpayer takes out a $500,000 mortgage to purchase a main home. The loan is secured by the main home. In February 2018, the taxpayer takes out a $250,000 loan to purchase a vacation home. The loan is secured by the vacation home. Because the total amount of both mortgages does not exceed $750,000, all of the interest paid on both mortgages is deductible. However, if the taxpayer took out a $250,000 home equity loan on the main home to purchase the vacation home, then the interest on the home equity loan would not be deductible.

Example 3

In January 2018, a taxpayer takes out a $500,000 mortgage to purchase a main home. The loan is secured by the main home. In February 2018, the taxpayer takes out a $500,000 loan to purchase a vacation home. The loan is secured by the vacation home. Because the total amount of both mortgages exceeds $750,000, not all of the interest paid on the mortgages is deductible. A percentage of the total interest paid is deductible (see Publication 936).

In conclusion, a literal reading of the language in the Act would indicate that interest on a home equity loan is no longer deductible, but recent IRS guidance provides clarification that though debt is classified as a home equity loan, interest on such a loan may still be deductible. For further guidance, please consult your tax advisor or the authors of this alert.

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