Mortgage and Home Equity Loan Interest Deductions Under the Tax Cuts and Jobs Act

Presented by Graziano Budny Wealth Management Group
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With its passage in December 2017, the Tax Cuts and Jobs Act (TCJA) changed the deductions for interest on mortgage and home equity loans. On February 21, 2018, the Internal Revenue Service (IRS) provided clarification on how the TCJA will be applied to mortgage and home equity loan interest deductions.

Initially, application of the TCJA was ambiguous because of (1) definitions from the 1986 "old" tax law and (2) the multiple ways to use home equity. The IRS's recent guidance establishes that the interest on *some* refinanced mortgages and home equity loans and lines of credit will be deductible under the TCJA if it qualifies as acquisition debt. Here, we'll answer some questions on how the TCJA is applied to mortgage and home equity loan interest, starting with a definition of residential debt.

How does the Internal Revenue Code define residential debt?
The mortgage interest deduction began under the Tax Reform Act of 1986 (a.k.a. the old tax law). This law allowed a deduction for qualified residence interest in two separate categories: acquisition indebtedness and home equity indebtedness. It defined "acquisition debt" as new or refinanced secured debt used to acquire, construct, or substantially improve a residence. It defined "home equity debt" as secured debt that could, but did not have to, be used to acquire, construct, or improve a house.

The TCJA did not change or modify either definition.

What interest can be deducted?
Prior to 2018, you could deduct interest on mortgage debt up to $1,000,000. The $1,000,000 could be either a single mortgage or a total combined mortgage debt on a primary residence and a vacation home.

You could also deduct up to $100,000 of the interest paid on home equity loans and lines of credit. This interest was deductible irrespective of how you used the loan proceeds. Debt consolidation? Deductible. College tuition? Deductible.

Under the TCJA, however, only acquisition debt qualifies for the interest deduction. Obviously, mortgages are loans for the acquisition or construction of a home. The TCJA caps the interest deduction for mortgages obtained after January 1, 2018, at $750,000. All mortgage debt secured before December 31, 2017, is grandfathered under the old rules. This means that the $1,000,000 limit still applies to mortgages that existed before the end of last year.

The TCJA also eliminates the interest deduction for home equity loans and lines of credit. Here, the TCJA contains no grandfather provisions. Even if a home equity loan or line of credit was taken before December 31, 2017, an interest deduction on its remaining balance may depend entirely on whether the debt is acquisition debt.

Will interest on a home equity loan or line of credit used for home improvement be deductible?
Yes. This is one of the ambiguities that the IRS has clarified. The TCJA kept the old tax law's definitions of acquisition debt and home equity debt; however, the TCJA looks only at the *use* of the debt. That is, interest is deductible if the loan is acquisition debt used to build, acquire, or improve a home. The fact that a primary residence secures a new home equity loan or line of credit is irrelevant.

Home equity loans and lines of credit are often, but not always, used to improve a residence. For example, a home equity loan used for debt consolidation or college tuition does not qualify as acquisition debt because it does not enhance the home's value. On the other hand, the same home equity loan used to build an addition that increases the home's cost basis and improves its market value meets the definition of acquisition debt.

Will a refinanced mortgage qualify as acquisition debt?
Yes. This is another aspect of the TCJA that initially lacked clarity. The original mortgage was acquisition debt. But what if part of the refinancing is used to pay off credit cards? The interest on that portion of the refinanced loan is not acquisition debt.

Was there general agreement that interest on a refinanced mortgage or home equity loan may be deducted if it meets the definition of acquisition debt?
No. Some tax preparers took a literal approach. They read the TCJA as barring a deduction for all home equity debt, irrespective of its use. Others took a more practical view. They interpreted the TCJA in conjunction with the old tax law's definition of acquisition debt. The IRS's recent guidance supports the practical view: interest on home equity loans and refinanced mortgages is deductible under the TCJA if the debt was used to acquire, construct, or improve residential property.

New territory
As you can see from this discussion, it's important to have a clear understanding of the rules regarding mortgage and home equity loan interest deductions under the TCJA. Given this new territory, be sure to track the use of your home equity debt so that you can provide your tax preparer with all supporting documentation.

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Graziano Budny Wealth Management Group is a financial advisory team located at 304 Inverness Way South, Suite 305, Englewood, CO 80112. They offer securities and advisory services as Investment Adviser Representatives of Commonwealth Financial Network®, Member FINRA/SIPC, a Registered Investment Adviser. They can be reached at 720-583-6363 or at jgraziano@grazianobudny.com, bbudny@grazianobudny.com, or mgraziano@grazianobudny.com.

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