Abstract: Passage of the Tax Cuts and Jobs Act has led to confusion over some longstanding deductions. In response, the IRS recently issued a statement clarifying the rules surrounding the deductibility of home equity interest. This article compares the old rules to these new ones.

Deducting home equity interest under the Tax Cuts and Jobs Act

Passage of the Tax Cuts and Jobs Act (TCJA) in December 2017 has led to confusion over some longstanding deductions. In response, the IRS recently 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.

How it used to be

Under prior tax law, a taxpayer 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 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.

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.

What’s deductible now

The TCJA limits the amount of the mortgage interest deduction for taxpayers who itemize through 2025. Beginning in 2018, for new home purchases, a taxpayer can deduct interest only on acquisition mortgage debt of $750,000.

On February 21, 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 deductible 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.

Further clarifications

As a relatively comprehensive new tax law, the TCJA will likely be subject to a variety of clarifications before it settles in. Please contact our firm for help better understanding this provision or any other.