The Tax Cuts and Jobs Act

Home acquisition interest and home equity interest changes

Under the pre-Tax Cuts and Jobs Act (TJCA) rules, you could deduct mortgage interest on up to $1 million of acquisition indebtedness. This deduction must be used to acquire, build or substantially improve your principal residence, or one other residence, and the debt was secured by that residence. For a married taxpayer filing separately, the limit was $500,000. You could also deduct any additional interest on home mortgage indebtedness or home equity indebtedness that was used for any other purpose, up to the next $100,000 of debt principal ($50,000 for a married taxpayer filing separately), not to exceed the taxpayer's equity in the home or homes (the excess of the value of the home over the acquisition debt). The deduction for home equity indebtedness was deductible for regular tax purposes, but not for alternative minimum tax (AMT) purposes.

Under the TCJA, starting in 2018, the limit on qualifying acquisition indebtedness is reduced to $750,000 ($375,000 for a married taxpayer filing separately). However, for acquisition indebtedness incurred before December 15, 2017, the higher pre-TCJA limit applies (the $1M limit). The higher pre-TCJA limit also applies to debt arising from refinancing pre-December 15, 2017 acquisition indebtedness, to the extent the debt resulting from the refinancing does not exceed the original debt amount. This means you can refinance up to $1 million of pre-December 15, 2017 acquisition debt in the future and not be subject to the reduced limitation.

And, importantly, starting in 2018, there is no longer a deduction for interest on home equity indebtedness. This applies regardless of when the home equity debt was incurred, pre- or post-TCJA.

There has been plenty of discussion on what is actually considered "acquisition indebtedness," and what qualifies as "home equity indebtedness." The type of classification of the type of debt you have is not based on how the loan was structured or what the bank (or mortgage servicer) calls it, but how the mortgage proceeds were actually used. To the extent the debt proceeds were used to acquire, build, or substantially improve the primary residence that secures a loan, it is acquisition indebtedness – even in the form of a home equity line of credit (HELOC) or home equity loan. The Internal Revenue Service (IRS) recently issued News Release 2018-32 on Feb. 21, 2018, clarifying that taxpayers can still deduct the interest on their home equity loans and HELOCs if the proceeds of the loan are used to buy, build, or substantially improve the qualified residence that secures the loan. On the other hand, even a "traditional" 30-year mortgage may not be deductible interest if it is a cash-out refinance and the cashed-out portion was used for other purposes.

Unfortunately, when you receive your Form 1098 reporting the interest you paid, it does not indicate if the underlying debt is acquisition indebtedness. This makes sense because the mortgage lender does not know how the proceeds were spent. Also, the mortgage servicer reports the full amount of the mortgage interest paid. You, as the taxpayer, are responsible for determining how much is (and isn't) deductible (albeit with the advice a tax professional). You are responsible for keeping adequate records and tracking the use of debt proceeds.

Other important items to note

- Acquisition debt and home equity debt must be secured by a primary or second residence. The property must be used as a residence, not as an investment or rental property.
- A second residence generally includes a house, condominium and boat provided it meets IRS requirements for sleeping, toilet and cooking space.
- Acquisition debt that is refinanced, retains its character as acquisition debt, to the extent of the original amount of the acquisition debt remaining.
- A "substantial improvement" to a home is based upon whether the improvements are capital improvements that would add to cost basis, such as an expansion or other permanent improvement, but does not include normal maintenance or repairs.
- A home equity line of credit (HELOC) can also be acquisition debt, if used to acquire, build, or substantially improve a residence.
- A mortgage loan does not need to be made by a traditional bank in order for it to qualify as acquisition debt. The proceeds just have to be used to acquire, build or substantially improve a residence and must be secured by that residence.
- If the proceeds of a cash-out refinance are not used to acquire, build or substantially improve a residence, then the debt will be treated as home equity debt.
- Reverse mortgage debt proceeds used to acquire, build or substantially improve the residence would be treated as acquisition debt, while reverse mortgage funds used for any other purpose would be treated as home equity debt.
- There are tracing rules for so-called "mixed-use mortgages," where a portion is acquisition debt and a portion is not.
- Debt incurred to acquire, build, or substantially improve a residence, but is not secured by that residence (for example, debt secured by the underlying securities in an investment account), does not qualify as qualified acquisition debt. This is treated as personal interest, which is not deductible.

The definitions and classification of debt as home acquisition or home equity are still the same under the new law. Both types still require the debt be secured by the residence. The implication of the TCJA is that there are new debt principal limits on acquisition debt and a different alternative minimum tax (AMT) treatment. Note that there were some grandfathering provisions for existing mortgages, the remaining debt balance of refinanced mortgages and homes that were already under a binding written contract when the law was passed. However, there is no grandfathering provision for existing home equity debt.

Now, mortgage interest is deductible if it is used to buy, build or substantially improve a residence, or is not deductible at all. Accordingly, if you are considering incurring home equity debt for any other purpose after incurring home equity debt in the future, you should take this factor into consideration.

And if you currently have outstanding home equity debt, be prepared to lose the interest deduction starting in 2018. You will still be able to deduct it on your 2017 tax return, filed in 2018. Therefore, you should consider paying off any home equity debt, since that debt is not deductible.

If the interest on the home equity debt is not deductible, you could consider ways that could potentially make it a deductible interest expense. For example, consider converting the property to investment rental property or make use of the property in a trade or business.

Lastly, both of these changes last for eight years, through 2025. In the absence of intervening legislation, the pre-TCJA rules come back into effect in 2026. So beginning in 2026, interest on home equity loans will be deductible again, up to $100,000 of debt and the limit on qualifying acquisition debt will be raised back to $1 million ($500,000 for married separate filers).

For more information, please contact your Key Private Bank Advisor.

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