BusinessManagement DAILY

APRIL 20, 2018

# Find loophole for home equity debt

The new tax law—the Tax Cuts and Jobs Act (TCJA) of 2017—cracks down on mortgage interest deductions for home equity loans. But there's a way you can tilt the new rules to your tax advantage.

**Strategy:** Use the proceeds of a home equity loan for home improvements. According to a literal reading of the new law, this can avoid the crackdown that begins in 2018.

It all has to do with the tax law distinction between loans treated as "acquisition debt" and those characterized as "home equity debt."

*Here's the whole story:* Under prior law, you could generally deduct "qualified residence interest" (commonly called "home mortgage interest") that you paid during the year. To qualify for the deduction, you must be legally obligated to pay the mortgage and it must be secured by a qualified home. The home may be your principal residence or one other home like a vacation home.

The deduction limit will depend on whether the debt is an acquisition debt or a home equity debt.

- **Acquisition debt:** This is a debt incurred to buy, build or substantially improve a qualified home. Prior to the TCJA, mortgage interest paid on up to $1 million of acquisition debt was fully deductible if you itemize.
- **Home equity debt:** Any other qualified debt, such as a home equity loan or line of credit, is treated as home equity debt. Under prior law, interest paid on up to $100,000 of home equity debt was deductible regardless of how the proceeds were used.

But now the TCJA changes the tax landscape. For acquisition debt, the threshold is lowered from $1 million to $750,000 for 2018 through 2025. The new limit generally applies to mortgage loans taken out after December 15, 2017. (However, deductions for up to $1 million of existing acquisition debt are grandfathered even if they are subsequently refinanced up to the remaining amount of debt.)

Even worse, the deduction for interest on home equity debt is eliminated for 2018–2025.

*Tax loophole:* If you take out a new home equity loan or line of credit and use the proceeds for home improvements—say, a finished basement or a new deck—the debt is treated as acquisition debt, rather than home equity debt. *Reason:* It is a debt incurred to "substantially improve" a qualified residence. Thus, the interest can be deducted going forward as long as you stay below the new $750,000 threshold for acquisition debt.

In fact, just a small change in the way you handle your money can salvage a deduction. For instance, if you were planning to use funds stashed in a bank account for a home improvement and take out a home equity loan to help pay for some of your child's college expenses, you might do the exact opposite. This converts a nondeductible interest expense into a deductible one.

***Tip:*** The IRS has okayed this interpretation of the rules. (*IRS Information Release IR-2018-32, dated 2/21/18*)


7600 Leesburg Pike, Suite 300, Falls Church, VA 22043-2004 (800) 543-2002