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Taxpayers can continue to deduct interest paid on home equity loans under the recently enacted Tax Cuts and Jobs Act

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For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the original language of the Tax Cuts and Jobs Act (the Act) indicated that "home equity debt" is no longer deductible. The elimination of the deduction for interest on home equity debt applied regardless of when the home equity debt was incurred. However, in a recent release, the IRS stated that despite the newly enacted restrictions on home mortgages under the Act, taxpayers can often still deduct interest on a home equity loan, home equity line of credit (HELOC) or second mortgage, regardless of how the loan is labelled.

In Information Release 2018-32 dated 2/22/2018, the IRS clarified that the Act "suspends the deduction for interest paid on home equity loans and lines of credit, ***unless*** the proceeds are used to buy, build or substantially improve **the taxpayer's home that secures the loan.**" This statement is important, as the illustration noted below demonstrates.

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. Under the Act, interest remains deductible on Schedule A as mortgage interest, if the loan is secured by the taxpayer's main home or second home (known as a qualified residence), and does not exceed the cost of the home, and meets other requirements.

As discussed in our report on the Tax Cuts and Jobs Act , the combined limit on acquisition debt generally incurred after December 15, 2017 used to acquire a principal residence and/or second home is $750,000 ($375,000 married filing separately). However, taxpayers need to exercise care in how the loan proceeds are used and documented. As noted in the second illustration provided in the release (and shown below), the incorrect form of the transaction could render interest on a loan non-deductible.

> Illustration 2:
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> In January 2018, Mary takes out a $500,000 mortgage to purchase a main home. The loan is secured by the main home. In February 2018, she 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 Mary 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.

The second example in the illustration is contrary with the language in the release that states that proceeds be “used to buy, build, or substantially improve the **taxpayer's home that secures the loan.**” Therefore the deduction is disallowed.

Because of the variety of limits imposed on interest deductions, the IRS provides special rules for allocating interest expense among the categories. These “tracing rules,” as they are called, are generally based on the use of the loan proceeds. Under the tracing rules, interest expense is allocated in the same way as the debt on which the interest is paid. The debt, in turn, is allocated by tracing the use of the debt proceeds to specific expenditures.

Although the release does not address these rules, there still may be an opportunity to deduct the interest if incurred on a HELOC or other mortgage loan and used for investment purposes such as for rental real estate or investment in S corporation stock via the tracing rules. Please contact Schneider Downs to discuss these rules further and determine the best option for you.

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