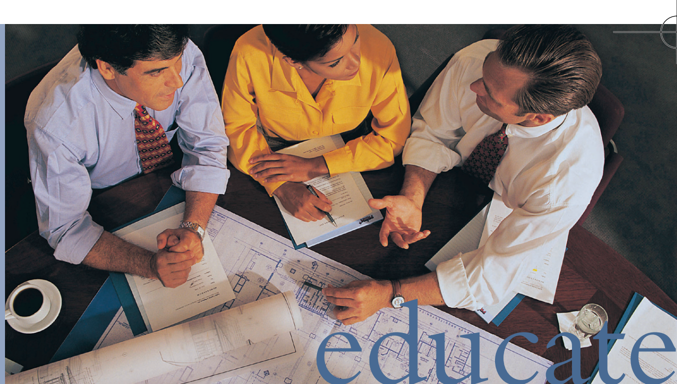

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Using Your Home Equity

Understanding The Limitations On Home Mortgage Interest Deductions

Client Information Series

A Source of Ready Cash

Home equity is a ready source of cash for purposes other than housing, and since consumer debt is not deductible as an itemized deduction, home equity has become a means to make consumer purchases and have the interest on debt for those purchases tax-deductible as home mortgage interest. The key is that the loan must be secured by the home. Take for example, purchasing a new car. Say the new car costs $25,000 and the trade-in is worth $5,000. That leaves a $20,000 loan. Assuming a rate of 8%, the interest paid over the term of the loan would be $4,333. If you finance the car through a home equity loan, the interest would be deductible, and assuming a combined Federal and state tax bracket of 25%, a homeowner would save $1,083 by having the tax deduction.

In addition to consumer purchases, home equity is frequently used for college expenses, paying off credit card debts, emergency medical expenses, etc. But always remember, the loan must be secured by the home, and if the total debt exceeds combined acquisition debt and equity debt limits, the excess is not deductible as home mortgage interest but may be deductible somewhere else on your tax return if the use of the loan proceeds can be traced to another deductible use.

Home Loans for Business

Frequently, homeowners may wish to borrow money from their home equity in order to meet a business need. This commonly occurs because banks are more willing to make secured home loans than they are to make business loans, and generally, home loans have a lower interest rate and a longer term. However, an interest deduction will generally provide greater benefit if deducted against the business rather than as an itemized deduction.

The question frequently arises whether the home mortgage interest can be allocated between the business and home in proportion to the amount of debt allocated between home and business purposes. Although tax law includes provisions to allocate interest, the provision does not apply to home mortgage interest. Basically, if the mortgage is secured by the home, then it must be deducted as home mortgage interest to the extent allowed by law and only the excess can be allocated. There is, however, a special election that allows home debt to be treated as if it were not secured by the home. If that election is made, then the interest can be allocated to its proper use, except that none of the interest can be allocated to the home since it is no longer secured by the home. If the homeowner refinanced the existing acquisition debt and took cash for the business and used the election, then the part allocable to the home would not be deductible. On the other hand, if a second mortgage was taken on the home and all of the proceeds used for business, then the election could be used since the entire amount of the interest would be allocated to the business activity.

Home Construction

A home under construction may be treated as a qualified residence for a period of up to 24 months, provided the home becomes a qualified residence as of the time it is ready for occupancy. In addition, the 24-month period may begin any time after construction begins. This means that if the construction takes more than 24 months, the final 24 months before the property is ready for occupancy can be used.

Watch Out for AMT!

The Alternative Minimum Tax (AMT) is another way of computing tax liability that is required to be used if it is greater than the regular method. Congress originally conceived the AMT as a means of extracting a minimum tax from high income taxpayers who have significant items of tax shelter and/or tax-favored deductions. Since the AMT was conceived, inflation has driven up income and deductions so that more individuals are becoming subject to the AMT. When computing the AMT, acquisition debt interest is allowed as a deduction. However, home equity debt interest is not. Neither is the interest on debt for unconventional homes such as boats and motor homes, even if they are the primary residence of the taxpayer. Therefore, if you are subject to the AMT, you need to make every attempt to avoid any debt other than the acquisition debt.

The advice included in this brochure is not intended or written by this practitioner to be used, and it cannot be used by a practitioner or taxpayer, for the purpose of avoiding penalties that may be imposed on the practitioner or taxpayer.

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Using Your Home Equity

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An individual's home is one of his/her most valuable assets, if not the most valuable. Over time, the home's mortgage will be paid down and the home generally will increase in value, providing a substantial amount of equity. Homeowners frequently look to the equity in their home as a source of ready cash to use for other purposes, such as purchasing vehicles, funding college educations, paying off credit card debts, etc. This may provide a tax benefit, because unlike a car loan, credit card debt, etc., home mortgage interest is normally tax-deductible. But not always! Don't become trapped by the limitations imposed by the tax laws on deducting home mortgage interest. At first glance, the rules regarding deducting home mortgage interest may seem quite uncomplicated. But there are a number of frequently encountered situations that can limit a taxpayer's home mortgage interest deduction. This brochure gives an overview of the more commonly encountered situations and hopefully provides you with sufficient awareness to recognize a potential problem so that you may seek professional assistance when the need arises.

Tax Law and Terminology

Understanding the laws relating to deducting home mortgage interest requires an understanding of the terminology used in tax law and regulations and the limitations imposed.

- **Acquisition Debt –** is generally the mortgage debt incurred to acquire, construct, or improve a taxpayer's "qualified residence" and is one that is secured by that residence. Deductible home mortgage interest is limited to the interest on the first $1 million[1] dollars of such debt. (Note: There is an exception for mortgages that exceed the $1 million limit and were acquired before Oct. 14, 1987, which is not covered in this brochure.)
- **Home Equity Debt –** is any debt, other than acquisition debt, secured by the taxpayer's "qualified residence" to the extent the debt does not exceed the fair market value of the residence reduced by the acquisition indebtedness. Deductible interest on home equity debt is limited to the interest on $100,000[2] of such indebtedness.
- **Qualified Residence –** means the taxpayer's principal residence and a second residence selected by the taxpayer.
- **Second Residence –** To qualify as a second residence, a property must be a residence that generally includes sleeping, cooking, and toileting facilities. Therefore, houses, condominiums, motor homes, boats, and house trailers can be treated as residences.
- **Residence Under Construction –** A residence under construction may be treated as a qualified residence the final 24 months before the property is ready for occupancy.
- **AMT Adjustments –** Only interest on acquisition debt is deductible against the Alternative Minimum Tax (AMT). Therefore, interest on home equity indebtedness would not be deductible for AMT calculation purposes. In addition, AMT rules generally do not allow interest on unconventional residences such as boats or mobile homes used on a transient basis.

Deducting Home Interest

Generally, when a taxpayer finances a home for less than $1,000,000[1], the interest on that loan would be fully deductible as part of the taxpayer's itemized deductions. The taxpayer can also deduct interest on home equity debt up to $100,000[2], provided the total of the acquisition and home equity debt does not exceed the fair market value (FMV) of the home. If it does, the interest on the home equity loan will be limited to that paid on the difference between the FMV and acquisition indebtedness. Sounds simple, but keep in mind the acquisition debt is not a fixed amount, since it continually declines over time. Figure #1 illustrates how the acquisition debt declines over the life of a loan.

(1) $500,000 for married individuals filing separately

(2) $50,000 for married individuals filing separately

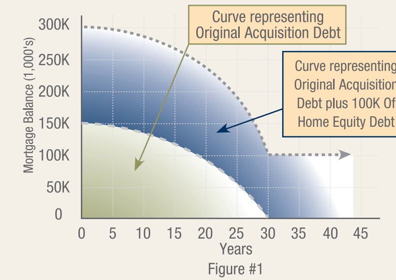

Figure #1

Implications of Refinancing

Suppose after several years, the prevailing interest rates for home loans decline, and the taxpayer decides to refinance the acquisition debt to take advantage of lower interest rates and at the same time take out an additional $100,000 for a home improvement? As illustrated in Figure #2, as long as the additional cash is used for home improvements, the term of the original loan can be extended and all the debt within the blue and red shaded areas continues to be allowable acquisition debt with the interest on that debt fully deductible as home mortgage interest.

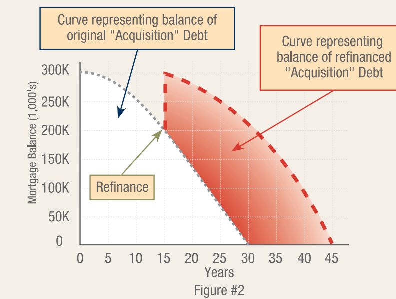

Figure #2

Suppose in another example, illustrated in Figure #3, the taxpayer decides to refinance and increase the loan by $150,000, but does not use any of the additional loan proceeds for home improvements. In this case, the original acquisition debt term is extended and retains its character as acquisition debt (blue shaded area). The prorated interest on this portion of the debt continues to be deductible against both the regular tax and the AMT. The next $100,000 of the additional proceeds qualifies as home equity debt (green shaded area). The prorated interest on this portion of the debt continues to be deductible against the regular tax, but not the AMT. The balance of the debt (red shaded area) does not qualify as either acquisition debt or equity debt and the prorated interest on this portion of the debt is not deductible either as acquisition debt interest or equity interest. However, if the use of this portion of the debt can be traced to another deductible purpose, the interest may be deductible elsewhere on the tax return.

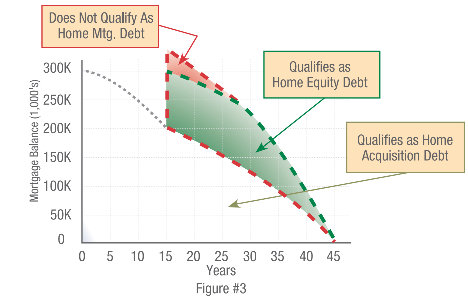

Figure #3

Increasing Acquisition Debt

Although acquisition debt will generally decline over time as the debt is paid off, it is possible for the debt to increase. The definition of acquisition debt is debt incurred to acquire, construct or improve a taxpayer's "qualified residence." Therefore, if a taxpayer borrows money to improve a home, that debt would be classified as acquisition debt and would add to the balance of any other acquisition debt still in existence. Currently, there is no official government explanation of the type or degree of work required for a substantial improvement. Presumably, the "improvement versus repair" rules would be relevant in determining whether there was a substantial improvement for purposes of the acquisition indebtedness rule.