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2019 Tax Filing Season (2018 Tax Year): Examples of Deducting Interest on Mortgage Debt and Home Equity Loans

Recent changes to the mortgage interest deduction have created some confusion among homeowners, particularly regarding the treatment of home equity loans. This In Focus explains the current tax treatment of mortgage interest and home equity loans resulting from the enactment of P.L. 115-97, often referred to as "The Tax Cuts and Jobs Act." Generalized examples are provided to illustrate how certain homeowners may be impacted by these recent changes.

Current Law (2018-2025)

A taxpayer may claim an itemized deduction for the interest paid on mortgage debt secured by a principal residence or a second home, subject to one of two limits on the amount of mortgage debt that qualifies for the deduction. Which limit is applicable depends on when the debt was incurred. A taxpayer may also deduct the interest on a home equity loan under certain circumstances.

For mortgage debt incurred before December 16, 2017, the deduction is limited to the interest on the first $1 million ($500,000 for married filing separately) of combined mortgage debt. For mortgage debt incurred on or after December 16, 2017, the deduction is limited to the interest incurred on the first $750,000 ($375,000 for married filing separately) of combined mortgage debt. Mortgage debt resulting from a refinance is treated as having been incurred on the origination date of the original mortgage for purposes of determining which mortgage limit applies.

The interest on home equity loans is deductible under two circumstances. First, the loan must be used to finance expenditures related to the home—for example, to remodel a kitchen. This restriction applies regardless of when the original mortgage or home equity loan home was originated. Second, the homeowner's combined mortgage debt on their primary and secondary residences, plus the balance on their home equity loan, cannot exceed the applicable loan limit ($1 million or $750,000).

Determining the applicable loan limit is slightly more complicated when a homeowner has mortgage and home equity debt that is subject to the $1 million limit (i.e., was incurred before December 16, 2017), and then later incurs debt that is subject to the $750,000 limit (i.e., was incurred on or after December 16, 2017). In this case, the older debt that is subject to the $1 million limit counts toward the $750,000 limit for any newer debt. This scenario is illustrated in Example 8 and Example 9 presented later.

Prior Law (2017)

Under prior law, a homeowner was allowed an itemized deduction for the interest paid on the first $1 million of combined mortgage. Homeowners were also allowed to deduct the interest paid on a home equity loan. However, a *separate and additional* limit of $100,000 applied to home equity loans that were used to finance costs unassociated with the home, such as paying for a child's college education. Thus, a homeowner's combined mortgage and home equity debt was capped at $1.1 million.

For more information on the recent changes, see CRS In Focus IF11063, *2019 Tax Filing Season (2018 Tax Year): The Mortgage Interest Deduction*, by Mark P. Keightley.

Examples

The interaction between the applicable mortgage limit and the use of proceeds from a home equity loan has been a source of confusion. The following examples illustrate how the current rules for deducting interest on mortgages and home equity loans apply.

In the examples presented below, it is assumed that the tax filers are a married couple filing jointly, have one home, and that their mortgage is secured by the underlying property. It is also assumed they are filing their 2018 tax return. To keep the examples tractable, only the information necessary to highlight the general tax treatment that applies is presented. Whether the scenarios presented below will apply to a particular taxpayer will depend on all the facts and circumstances of their case.

Example 1

Mortgage:

- Origination date: January 1989.
- Current mortgage balance: $0.

Home equity loan:

- Origination date: July 2018.
- Home equity loan balance: $50,000.
- Used for: Payoff student loans.

The couple has no mortgage interest to deduct and would not be allowed to deduct the interest associated with home equity loan because the proceeds were not used to improve their home.

Example 2

Mortgage:

- Origination date: January 1989.
- Current mortgage balance: $0.

Home equity loan:

- Origination date: July 2016.
- Home equity loan balance: $50,000.
- Used for: Payoff student loans.

The couple has no mortgage interest to deduct and would not be allowed to deduct the interest associated with home equity loan. Even though the home equity loan was originated before December 16, 2017, the proceeds were not used to improve their home.

Example 3

Mortgage:

- Origination date: February 2018.
- Current mortgage balance: $600,000.

Home equity loan: None

The couple would be allowed to deduct all mortgage interest paid because they are below the applicable loan limit ($750,000) for mortgages originated on or after December 16, 2017.

Example 4

Mortgage:

- Origination date: February 2018.
- Current mortgage balance: $600,000.

Home equity loan:

- Origination date: November 2018.
- Home equity loan balance: $100,000.
- Used for: Home remodel.

The couple would be allowed to deduct all mortgage interest paid because they are below the applicable loan limit ($750,000) for mortgages originated on or after December 16, 2017. They would also be allowed to deduct the interest paid on the home equity loan because the proceeds were used to improve their home and their total combined debt (mortgage plus home equity loan) is less than $750,000.

Example 5

Mortgage:

- Origination date: February 2018.
- Current mortgage balance: $600,000.

Home equity loan:

- Origination date: November 2018.
- Home equity loan balance: $100,000.
- Used for: Children's college education.

The couple would be allowed to deduct all mortgage interest paid because they are below the applicable loan limit ($750,000) for mortgages originated on or after December 16, 2017. They would not be allowed to deduct the interest paid on the home equity loan because the proceeds were not used to improve their home.

Example 6

Mortgage:

- Origination date: February 2015.
- Current mortgage balance: $800,000.

Home equity loan: None

The couple would be allowed to deduct all mortgage interest paid because they are below the applicable loan limit ($1 million) for mortgages originated before December 16, 2017.

Example 7

Mortgage:

- Origination date: February 2015.
- Current mortgage balance: $800,000.

Home equity loan:

- Origination date: November 2016.
- Home equity loan balance: $90,000.
- Used for: Home remodel.

The couple would be allowed to deduct all mortgage interest paid because they are below the applicable loan limit ($1 million) for mortgages originated before December 16, 2017. They would also be allowed to deduct the interest paid on the home equity loan because it was originated before December 16, 2017, the proceeds were used to improve their home, and their total combined debt (mortgage plus home equity loan) is less than $1 million.

Example 8

Mortgage:

- Origination date: February 2015.
- Current mortgage balance: $800,000.

Home equity loan:

- Origination date: November 2018.
- Home equity loan balance: $90,000.
- Used for: Home remodel.

The couple would be allowed to deduct all mortgage interest paid because they are below the applicable loan limit ($1 million) for mortgages originated before December 16, 2017. They would not be allowed to deduct the interest paid on the home equity loan because debt incurred before December 16, 2017, counts toward the $750,000 limit for debt incurred on or after December 16, 2017.

Example 9

Mortgage:

- Origination date: February 2015.
- Current mortgage balance: $700,000.

Home equity loan:

- Origination date: November 2018.
- Home equity loan balance: $90,000.
- Used for: Home remodel.

The couple would be allowed to deduct all mortgage interest paid because they are below the applicable loan limit ($1 million) for mortgages originated before December 16, 2017. They would be allowed to deduct the interest paid on the first $50,000 of their home equity loan because the $750,000 limit for debt incurred on or after December 16, 2017, is reduced by the amount of debt incurred before December 16, 2017. Thus, they have $750,000 - $700,000 = $50,000 left under the limit that applies to new debt.

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