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Home loan deductions: New rules, new responses

There is still potential to create tax efficiencies–if you are strategic

By Thomas McGraw, Head of Tax Advisory,
Jordan Sprechman, U.S. Wealth Advisory Practice Lead, and
Christina Reda, Tax Advisory, J.P. Morgan Private Bank

All U.S. income tax deductions were threatened last year while Congress debated a tax overhaul–and when the new law was finally passed, many were lost or curtailed. But a few key deductions remain, especially those related to loans secured by your home.

If you purchase a primary or secondary home, you can still deduct mortgage interest, but your deduction is now limited to the interest you pay on $750,000 of debt, down from the $1 million of principal allowed previously. The new tax law also eliminated the $100,000 deduction for interest on home equity lines of credit (HELOCs)[1] –unless the loan is used for specifically deductible purposes. The deduction for investment interest, however, was left intact. So what do these changes mean for you?

If you want to buy a new home or refinance existing debt, this article provides insights into the rules that are set to be in effect through the end of 2025, when these provisions are scheduled to sunset.

There are three key principles to bear in mind:

01 Your mortgage may still qualify for the higher deduction (interest on $1 million of principal)

02 HELOC interest is still deductible in some cases

03 You still can borrow strategically to reduce your effective interest rate

To customize these options to your particular situation and fit them into your overall wealth plan, please consult your J.P. Morgan advisor and outside tax advisors.

For a quick view of the new rules, see “Rules of the road: Taking tax deductions for loan interest” on page 7.

THREE PRINCIPLES TO LEVERAGE NOW

01 YOUR MORTGAGE MAY STILL QUALIFY FOR THE HIGHER DEDUCTION

While the new law reduced the limit for interest you can deduct on new mortgages to that on principal of $750,000, you can still deduct the interest on up to $1 million of principal on any mortgages incurred before December 15, 2017, thanks to a grandfathering provision in the new tax law.[2]

You may even refinance your mortgage and be grandfathered under the higher $1 million cap–to the extent that the amount of your refinanced mortgage is no greater than the debt you’re refinancing.[3] However, you have a limited period of time to refinance a grandfathered mortgage and still qualify for grandfathered treatment.

That period ends after:

A. The term of your original debt expires

Or

B. If your loan principal is not amortized (for example, you have an interest-only mortgage), the earlier of:

- The end of the term of your first refinancing

  Or

- 30 years after the date of your first refinancing[4]

In other words, there are seemingly no limits to the number of times you can refinance and benefit from the grandfathering provision, but there is a finite amount of time in which to do so.

Two examples highlight the new limits.

LIMIT A: TED REFINANCES BEFORE THE ORIGINAL LOAN TERM EXPIRES

In 1989, ***Ted*** incurred a 30-year, $2 million mortgage.

In 2018, when he had $800,000 of principal outstanding, he refinanced with new expiration in 2048.

Because Ted's original mortgage would not have expired until 2019, he is able to deduct interest on all $800,000 because he is grandfathered under the $1 million cap.

LIMIT B: MADISON REFINANCES AN INTEREST-ONLY MORTGAGE

In 2000, ***Madison*** took out a 40-year, $1 million interest-only mortgage.

In 2010, she refinanced with new expiration in 2050.

The new mortgage is grandfathered under the $1 million limit because Madison refinanced before 2040, which is the earlier of her two potential deadlines:

- 2050—the expiration of the term of the first refinancing

  Or

- 2040—30 years after the date of the first refinancing

02 HELOC INTEREST IS STILL DEDUCTIBLE IN SOME CASES

HELOCs previously had their own $100,000 deduction under the "qualified residence interest" rules—the same rules under which mortgage interest is deductible. HELOC proceeds could be used for any purpose so long as the debt was secured by a primary or secondary residence.

The new tax law eliminated the ability to deduct interest on HELOCs under these rules. However, recent IRS guidance indicates you may still deduct interest on HELOCs if you use the debt proceeds for "acquisition indebtedness."[5] To qualify for the "acquisition indebtedness" mortgage deduction, the debt proceeds must:

- Be used to buy, build or substantially improve the taxpayer's primary or secondary home

  And

- Be secured by the home that is bought, built or substantially improved[6]

The former $100,000 cap no longer applies, so interest on qualifying HELOCs is deductible so long as the total "acquisition indebtedness" does not exceed $750,000.

What if home equity loan proceeds are used for other deductible expenses, such as taxable investments?

While the recent IRS guidance only explicitly spoke of HELOC proceeds tracing to mortgage-related uses and qualification for the mortgage deduction, it stands to reason this logic can be extrapolated to other deductible uses, such as purchasing taxable investments.[7] In this case, the deductibility of HELOC proceeds should be uncapped.

HOW HELOCS MAY STILL BE DEDUCTIBLE[8]

EXAMPLE A

Jane can deduct interest on HELOC proceeds used to build an addition to her newly purchased home:

In January 2018, Jane, who is married and filing a joint return, took out a $500,000 mortgage to purchase her main home, which had a fair market value of $1 million.

A month later, she took out a $250,000 HELOC to put an addition on this home.

Both loans are secured by this primary residence, and the total debt does not exceed the cost of the home.

Because the total amount of both loans does not exceed $750,000, all of the interest is deductible on both of her loans, the $500,000 mortgage and the $250,000 HELOC.

However, Jane would lose the HELOC deduction if she used the HELOC proceeds for personal expenses, such as paying off student loans and credit cards.

EXAMPLE B

Whether Brendan can deduct interest on HELOC proceeds used to purchase his vacation home depends on which of his properties secures the HELOC:

In January 2018, Brendan took out a $500,000 mortgage to purchase his main home. The loan is secured by this primary residence.

A month later, Brendan took 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 Brendan took out a $250,000 home equity loan on his main home to purchase his vacation home, then the interest on his home equity loan would not be deductible.

EXAMPLE C

Todd can deduct only a portion of the interest on loans secured by his homes:

In January 2018, Todd took out a $500,000 mortgage to purchase a primary residence. The loan is secured by this home.

A month later, Todd took out a $500,000 loan to purchase a vacation home. This second loan is secured by the vacation home.

Because the total amount of both mortgages exceeds $750,000, only a percentage of the total interest paid is deductible.[9]

03 YOU CAN STILL BORROW STRATEGICALLY TO REDUCE YOUR EFFECTIVE INTEREST RATE

There are two unchanged aspects of tax law that you can still put to great use. You may deduct interest expense if you use the proceeds to:

- Buy taxable investments (under the deduction for investment interest expense, deductible up to the amount of your net investment income for the year)

  Or

- Invest in a pass-through trade or business in which you materially participate (under the deduction for trade or business expense)

These uncapped deductions offer incentives for you to borrow so you can invest or make capital commitments to a business. They also provide you with an opportunity to structure debt in a tax-efficient way. While these deductions are not specific to loans secured by residential properties, we'll focus on a few ways they could be applied to such loans.

However, you must proceed with caution and on the advice of your tax counsel when restructuring your debt to make sure you do not inadvertently run afoul of IRS rules.[10]

How tax-aware borrowing might work:

1. Use cash to pay down your mortgages in excess of the deductible amounts
2. Sometime later,[11] borrow against your properties
3. Invest the proceeds of these loans either in your trade or business, or in taxable investments
4. Elect out of the qualified residence interest rules on the refinanced mortgage so that the mortgage deductibility rules no longer apply

Instead, the deductibility of the interest should be determined solely by tracing the use of the debt proceeds, so the interest on debt in excess of the mortgage caps should be fully deductible as either investment interest, or trade or business expense.

TAX-AWARE BORROWING

EXAMPLE A

Grace could have significantly reduced her effective loan rate:

In 2015, Grace, a Florida[12] taxpayer, purchased a $5 million primary residence with a $4 million jumbo mortgage.

Her interest on the mortgage indebtedness qualifies for the mortgage deduction and is grandfathered under the $1 million cap. Grace's $3 million of additional mortgage indebtedness is non-deductible personal debt.

Grace could have taken the following steps to make her borrowing significantly more tax-efficient:

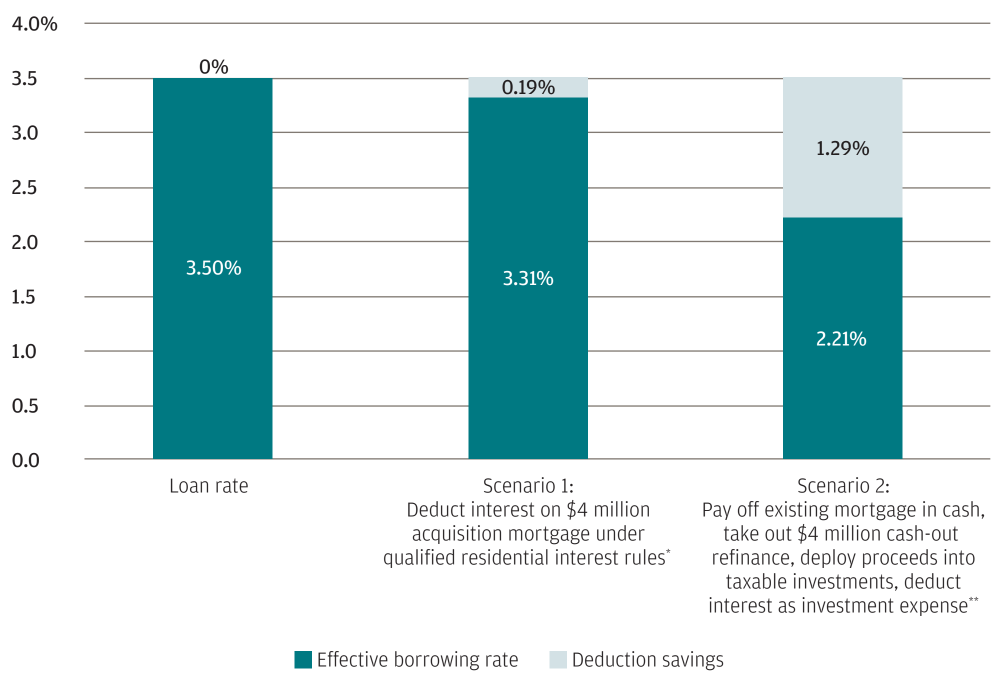
- Purchased her residence with cash (perhaps raised by offsetting gains and losses in a trading account)
- At a later date (long enough that she was exposed to market and interest rate risk), she might have mortgaged her residence and invested the loan proceeds in other taxable investments
- Elected out of the mortgage deductibility rules so that deductibility would trace to the purchase of taxable investments

Had Grace taken these steps, she could have reduced her effective borrowing rate. The loan rate was 3.5%. Her effective borrowing rate was 3.31% due to the $1 million mortgage deduction cap. With an unlimited investment interest deduction, Grace could have achieved an effective borrowing rate of just 2.21%. See "Deduction makes a difference" on the next page.

Not only is the investment expense deduction allowed on an unlimited amount of principal, it is (unlike the mortgage deduction) also deductible for purposes of the 3.8% Medicare surtax.

TAX-AWARE BORROWING *continued*

Deduction makes a difference



* Assumes property meets the definition of a qualified residence under the Internal Revenue Code. Mortgage interest on a qualified residence is only deductible if the mortgage proceeds are used to acquire, construct or substantially improve the property.

** Assumes taxpayer pays off existing $4 million mortgage with cash. After a lapse of time with exposure to market and interest rate risk, taxpayer takes out a $4 million mortgage on the property and elects for tax purposes to treat the loan as not secured by the qualified residence. Mortgage proceeds are invested in a portfolio of taxable securities, and interest is deducted as an investment expense.

For illustrative purposes only. Actual rate subject to change.

Assumes an interest-only payment structure. If mortgage payments are amortized, the taxpayer's interest deduction will vary each tax year.

Assumes existing mortgage is grandfathered under prior law and interest on up to $1 million of principal is deductible.

Assumes a $24,000 standard deduction for married joint filers in 2018. Taxpayer assumed to have $10,000 of other itemized deductions. Therefore, there is no tax benefit to the first $14,000 of deductible interest.

Assumes a 37% federal ordinary income tax rate. The investment interest expense deduction also offsets income with respect to the 3.8% Medicare surtax on net investment income.

Assumes taxpayer realizes sufficient ordinary investment income in his or her portfolio to claim the entire investment interest expense deduction.

TAX-AWARE BORROWING *continued*

EXAMPLE B

Patrick bifurcates debt so two types of deductions apply:

Patrick wants to refinance a $1 million mortgage he has outstanding from 2014. He wants to increase the debt to $1.6 million so that he can use the extra $600,000 to purchase taxable investments.

Patrick should be able to bifurcate the debt for tax purposes:

- His original mortgage—Because this was used to acquire the property, the interest on the (grandfathered) $1 million used to replace that existing debt would trace to the acquisition of the property and would be deductible as qualified residential interest
  - His original loan was taken in 2014, so it is grandfathered; a mortgage deduction will be allowed up to $1 million
- The extra $600,000—If used to purchase taxable investments, the interest on this amount would be deductible under the investment interest expense rules
  - Moreover, because Patrick is taking advantage of the mortgage deduction up to the $1 million cap, he does not need to elect out of the qualified residence rules for the interest on the incremental $600,000 to qualify as investment interest expense because that amount could not, by definition, be qualified residential interest[13]

EXAMPLE C

Seth likely can deduct interest on a home equity loan due to his use of the proceeds:

In 2007, Seth took out a $1.5 million mortgage to buy a house. The current outstanding balance is $1 million.

In 2016, he also took out a $250,000 HELOC to buy taxable investments.

The new tax law removed the HELOC deduction from the qualified residence interest rules.

Still, because the HELOC proceeds were used to acquire taxable investments, Seth should be able to deduct the HELOC interest as investment interest expense.[14]

At the same time, because the mortgage was taken out before December 15, 2017, it is grandfathered under the $1 million principal limit. Therefore, his mortgage interest continues to be deductible as qualified residence interest.

HOW WE CAN HELP

While the new tax law has laid out many new rules, many details need clarification. Treasury is hard at work implementing the tax act, and further guidance is expected.

Keep an eye out for the latest *Washington Watch Spotlights* to help you stay informed of major developments and our insights into them.

We also are available to work with you and your other advisors to help you navigate the post-tax act environment.

Rules of the road

Taking tax deductions for loan interest

Type of debt	Limit on deductibility*	Purposes for which interest is deductible
Mortgage acquisition indebtedness	Interest on up to $750,000 of aggregate indebtedness secured by a principal and one secondary personal residence**	Buy, build or make capital improvements on the properties securing the loan
Home equity line of credit***	Not deductible unless proceeds used for a deductible purpose	Buy, build or make capital improvements on the properties securing the loan (principal limit above applies) Purchase of investments (see next row) or capital contributions to a business
Investment interest expense****	No cap Deduction may offset taxable investment income only; carryover permitted if borrowing cost exceeds taxable investment income	Purchase of investments that would generate taxable income (e.g., no purchase of tax-exempt investments) Collateral cannot be tax-exempt investments Deductible interest allocations also may be required if tax-exempt investments are carried

*Taxpayers must itemize to benefit from these deductions.

**Qualified residence interest includes up to $750,000 of acquisition indebtedness (mortgage principal) for married taxpayers filing jointly. Interest on mortgage indebtedness incurred before December 15, 2017, is grandfathered up to the prior $1 million principal limit (or, if less, the balance outstanding). Acquisition indebtedness is generally deductible for Alternative Minimum Tax purposes as well, although at a reduced (up to 28%) marginal tax rate. The reduction in the mortgage deduction limit from $1 million to $750,000 is scheduled to sunset at the end of 2025.

***In 2026, the suspended deduction for up to $100,000 of home equity indebtedness will be reinstated. See I.R. 2018-32 for comments about the deductibility of home equity indebtedness.

****Interest expense can also reduce a taxpayer's net investment income that would otherwise be subject to the 3.8% Medicare surtax on unearned income.

[1] The $1 million limit applied to married taxpayers filing jointly; the limit for married taxpayers filing separately was $500,000. Similarly, the $100,000 HELOC deduction applied to married taxpayers filing jointly; the limit for married taxpayers filing separately was $50,000.

[2] There is also a grandfathering exception for taxpayers who, before December 15, 2017, entered into binding contracts, before January 1, 2018, to close on the purchase of a principal residence, and who purchased the residence before April 1, 2018.

[3] A refinanced mortgage will be considered to have been incurred on the date of the original debt (and thus to qualify for the grandfathered limit) to the extent the amount of the resulting debt doesn't exceed the amount of the debt refinanced.

[4] Guidance may be needed to clarify whether the first prong (i.e., the expiration of the term of the original indebtedness) applies only to amortizing loans, or whether it is also available to non-amortizing loans.

[5] In February 2018, the IRS released IR 2018-32, clarifying that HELOC indebtedness that traces to uses consistent with the "acquisition indebtedness" rules are still deductible.

[6] HELOCs, by definition, must be secured by a qualified residence.

[7] The interest on HELOCs, the proceeds of which are used to purchase taxable investments, may be fully deductible as investment interest expense under the tracing doctrine rules of Temp. Reg. 1.163-8T. It may be necessary to first elect out of the qualified residence interest rules under Temp. Reg. § 1.163-10T(o)(5) such that the loan is not treated as secured by the residence. The qualified residence interest rules then would not apply, and deductibility would be determined solely by tracing the use of the proceeds. This election is effective for the tax year for which the election is made and for all subsequent tax years, unless revoked with IRS consent.

[8] These three examples are direct adaptations from the IRS guidance issued in I.R. 2018-32.

[9] See IRS Publication 936 to calculate how much would be deductible.

[10] Specifically, you want to beware of triggering the step transaction doctrine: The step transaction doctrine is a tax case law doctrine that requires that transactions be taxed according to their substance and not their form, such that separate steps of an overall transaction could be treated as a single transaction if the steps can be fairly integrated and are not discerned to have truly independent purposes. Under the step transaction doctrine, not only can separate steps be integrated, but steps can be reordered for tax purposes.

[11] The appropriate length of time should be discussed with outside tax and legal advisors, but should be long enough to subject the taxpayer to rate and market risk so as to avoid the disallowance of the investment interest expense deduction under the step transaction doctrine.

[12] To isolate the impact of federal taxes, we use Florida in this example because it does not tax income.

[13] The IRS has ruled that, to the extent debt exceeds the qualified residence limitations, deductibility is determined solely by tracing the use of the debt proceeds.

[14] Consult with your tax and legal advisors before implementing a similar strategy.